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# In the Supreme Court of the United States.

OCTOBER TERM 1919.

MARK EISNER, COLLECTOR OF INTERNAL revenue, plaintiff in error,
*v.*
MYRTLE H. MACOMBER, DEFENDANT in error.
No. 318.

*IN ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF NEW YORK.*

## SUPPLEMENTAL BRIEF FOR THE PLAINTIFF IN ERROR.

This case having been remanded to the docket for reargument, it may be helpful, in a supplemental brief, to restate as concisely as possible the contentions of the Government in view of what was said at the hearing and to reply specifically to some of the arguments advanced on behalf of the defendant in error.

### THE CASE.

Briefly stated, the case is this:

During the year 1916, the defendant in error, being the owner of 2,200 shares of the stock of the Standard Oil Company of California, received, as a stock

dividend, 1,100 shares of the stock of that company, of which 198 and a fraction shares represented earnings which had accrued to the company subsequent to March 1, 1913. She was required to include the *par value* of these 198 shares in her taxable income for 1916, though the *market value* was much greater. Having paid the tax, she sued to recover it and has succeeded in the District Court.

### STATUTE INVOLVED.

The case arises under the revenue act of 1916, 39 Stat. ch. 643, pp. 756, et seq.

Section 1 (a) imposes an income tax of 2 per cent, called the *normal tax*, on net incomes received in the preceding calendar year from all sources by *individuals*.

Section 10 imposes an annual tax of 2 per cent on net incomes received in the preceding calendar year from all sources by *corporations*.

Section 1 (b) imposes another annual tax, called the *additional tax*, on all net incomes of *individuals* in excess of $20,000. No tax corresponding to this is imposed on the income of *corporations*.

Section 2 (a) defines *net income* as including "gains, profits, and income *derived from* salaries, wages * * *, also from interest, rent, dividends" * * *, and defines dividends as—

> any distribution made or ordered to be made by a corporation, joint-stock company, association, or insurance company, *out of its earnings or profits accrued since March first, nineteen hundred and thirteen, and* payable to its

> shareholders, *whether in cash or in stock of the corporation*, joint stock company, association, or insurance company, which stock dividend shall be comsidered income, to the amount of its cash value.

Section 5 (b) provides that income from *dividends upon the stock or from the net earnings* of corporations which are themselves taxable on their net incomes, shall be *excluded* from the taxable income of individuals for the purposes of the *normal tax*. And Section 1 (b) provides that such income shall be *included* for the purposes of the *additional tax*.

Section 3 provides that for the purpose of the *additional tax*, the taxable income of an individual shall include his share of the undivided profits of a corporation if they have been permitted to accumulate beyond the reasonable needs of the business for the purpose of evading the tax.

The pertinent features of the Act are:

1. Congress has assumed the power to tax corporate gains and profits as income of either the corpotion or the stockholders, but has been careful not to impose the same tax on the same gains as the income of both.

2. A tax of 2 per cent is laid alike upon the net incomes of individuals and of corporations. But there is excluded from the taxable income of individuals all amounts received from the net earnings of corporations whose income is subject to the tax. Congress thus elected to impose this particular tax on corporate gains as income of the *corporation* rather than of the stockholders.

3. In imposing the *additional tax*, the opposite course was pursued. It is not laid on the income of *corporations* at all, but only on the income of *individuals*. And there is an express provision that the income so taxed shall include income derived from the net earnings of corporations. Congress thus elected to impose this additional tax on corporate gains as income of the *stockholders* rather than of the *corporation*.

4. In both cases, the tax is imposed on the same corporate gains. The only difference is that, in one case, the corporation pays the tax before passing the gains to the stockholders for whose benefit they have been earned, while in the other the stockholder pays the tax after he has received his share of the gains.

5. Since the tax is imposed upon income derived from dividends on capital stock or from the net earnings of corporations, and since dividends themselves are derived from net earnings, the ultimate thing taxed is *income derived from the net earnings of corporations*.

6. Such income, when derived from earnings *accruing prior to March 1, 1913*, is not subject to either the normal or the additional tax.

7. When derived from earnings accruing *since March 1, 1913*, it is not subject to the *normal tax*.

8. When so derived, it is subject to the *additional tax* and is taxed *when received*.

9. Such income is deemed to be *received* during the calendar year in which it comes to the stockholder in the form of either a *stock* or a *cash* dividend,

or in which the corporation fraudulently permits its gains and profits to accumulate beyond the reasonable needs of the business.

### QUESTION INVOLVED

The *purpose* of Congress to treat stock and cash dividends alike for purposes of the additional tax is plain beyond dispute. The sole question is whether it has the *power* to tax, as a stockholder's income, corporate gains and profits when they are received by him in the shape of additional stock issued as a stock dividend.

### THE CONTENTIONS.

The defendant in error contends that the tax is levied *on stock dividends per se;* that such dividends are mere readjustments of the evidence of a person's ownership and give the stockholder nothing that was not already his; that he is no richer after than before the dividend and so receives no income; and that stock dividends, for these reasons, not being income, can not be made such by congressional enactment.

The Government contends that the tax is levied on *income derived from corporate earnings;* that such income may be taxed either as the earnings accrue to the corporation or when they are *received* by the stockholder; that the act taxes it when received, but defines the word "received" so as to include not only stock dividends but, in one contingency, accrued earnings, though undistributed; that stock issued as a stock dividend is one of the forms in which corporate gains

may be received, measures the extent to which such gains have made the stockholder richer, and is, in truth, the income which he has derived from capital invested in corporate stock.

The defendant in error seeks to make the test whether the mere declaration of a stock dividend makes the stockholder richer the moment after than he was the moment before.

The Government says the true test is whether his previous investment has made him richer to the extent of the profits distributed by means of a stock dividend.

ACT OF 1913 AS APPLICABLE TO CORPORATE EARNINGS.

After the adoption of the Sixteenth Amendment abolishing all distinctions between incomes as to the manner in which they were taxable, the work of Congress in formulating the policy of the Government with respect to income taxes began with the act of 1913 (38 Stat. ch. 16, pp. 114, 166). That act provided for a normal and also an additional tax to be imposed annually on net incomes of individuals "arising or accruing" from all sources during the preceding calendar year. For the purpose of the normal tax, net income was not to include "the amount received as dividends upon stock or from the net earnings of any corporation * * *" which is itself taxable upon its net income. But, for the purpose of the additional tax, there was to be included income from all sources, "corporate or otherwise."

The provisions for taxing income arising or accruing from corporate sources were, (1) to require a

stockholder to report, as a part of his income, all "dividends," and (2) to tax, as income of stockholders, profits permitted by a corporation to accumulate beyond the reasonable needs of the business. There was no effort to define dividends.

### CHANGES MADE BY ACT OF 1916.

In framing the act of 1916, Congress must be assumed to have had in contemplation the act of 1913 and the controversies that had arisen under it. In so far as the two acts differ, it must be assumed that the purpose was to correct mistakes made through the use of language which was inapt to express what was really intended, or to make changes which experience had shown to be desirable. Important changes were made. The expression, "income accruing or arising" was discarded and the more definite expression, "income received" employed. But the most significant change was accomplished by adding a proviso to the effect that the term "dividends" shall be held to mean any distribution which a corporation makes or orders to be made—

> out of its earnings or profits accrued since March first, nineteen hundred and thirteen, and payable to its shareholders, whether in cash or in stock of the corporation, . . .

It is thus made plain that whatever is received by way of a dividend of whatever kind, including stock dividends, is to be taxed, but only when the dividend is declared out of earnings accrued since March 1, 1913.

The net result is that the act by no means assumes the want of power to treat as stockholder's income corporate earnings either as they accrue to the corporation or when they are received by the stockholder. Nor has Congress refrained from exercising that power. On the contrary, the act is based on it. It is exercised by imposing the tax, according as circumstances seemed to require, on corporate earnings at every stage through which they ever pass from their accrual to their arrival in the pocket of a stockholder, as follows:

1. They are taxed while still undistributed and in the hands of the corporation if they have been permitted to accumulate beyond the needs of the business.

2. In the absence of such fraudulent accumulation, they are taxed only when they are distributed by means of either a cash or a stock dividend.

In either case, the tax is on the stockholder's share in corporate earnings. No purpose to entirely exempt such share is expressed or implied. It is exempt only so long as it remains a part of such undivided profits as are reasonably necessary to the business. The moment it assumes any one of the forms named—fraudulently accumulated profits, cash dividend, or stock dividend—it is to be taxed.

### THE FACTS.

On March 1, 1913, the Standard Oil Company of California, had a paid up capital of $49,686,656.00, represented by 496,866 and a fraction shares, and

undivided profits of $20,353,068.34, making the actual value of each share of stock, in round numbers $141.00.

On January 1st, 1916, it had the same paid up capital, $20,353,068.34 of profits earned *before* March 1, 1913, and $24,499,194.68 earned after that date, and the value of each share of stock was approximately $190.00. It decided, in the language of the act of Congress, to *distribute* $24,843,327.74 of its accumulated earnings or, in the language of counsel for defendant in error, to *readjust* the evidence by which the stockholders held their interests in the corporate assets. Accordingly it declared a 50 per cent stock dividend and issued 248,433 and a fraction new shares of stock which it distributed among its stockholders.

To accomplish this, it capitalized all the profits which had been earned prior to March 1, 1913, and $4,490,259.40 which had been earned later, leaving $20,008,935.28 of the latter earnings undistributed. Since there were then outstanding 745,299 shares of stock, the value of each share was about $127.00. Approximately 18 per cent of the profits capitalized, distributed, or readjusted had thus accrued since March 1, 1913. The stockholders, as a whole, had their original 496,866 shares, 203,530 shares representing the earnings up to March 1, 1913, and 44,903 shares representing earnings after that date.

The defendant in error owned 2,200 shares of the original stock which had an actual value, on March 1, 1913, of $310,200 which, by reason of subsequent earnings had, on January 1, 1916, been increased to

$418,000. After the dividend, she had the original 2,200 shares to which had been added 902 shares, making 3,102 shares of the total par value of $310,200, the exact value of her investment on March 1, 1913. In addition, she had 198 shares of the par value of $19,800 which was her share of that portion of the earnings accruing after March 1, 1913, which the company had distributed or readjusted.

The actual value of both her original and her new shares was more than par because the company still had undivided profits in excess of $20,000,000.00. But what was actually capitalized or distributed in the form of capital was an amount equal to the par value of the new shares. Hence the tax in question was assessed only on defendant in error's share of the gains accruing after March 1, 1913, which were distributed by means of a stock dividend, or on the par value of 198 shares.

## BRIEF.

**The fundamental and controlling fact is that defendant in error is richer than she was on March 1, 1913, to the extent of 198 shares of Standard Oil stock which actually and in truth constitute a gain which she has derived from capital.**

On March 1, 1913, defendant in error owned 2,200 shares of stock of the par value of $220,000 which, on account of undivided profits, were, in fact, worth $310,200. In 1916 she received her share of these undivided profits in the form of 902 shares of new stock. She then had 3,102 shares of stock representing exactly the value of her investment as it stood on March 1, 1913, and the earnings accruing after

that date remained undivided. Enough of the latter earnings were then converted into stock to give her an additional 198 shares. These 198 shares are hers solely because, after March 1, 1913, the corporation caused her capital to earn $19,800. And it is only this amount which she has been required to treat as taxable income.

The outstanding fact upon which the Government rests its right to the tax in question cannot be gainsaid. *It is that, to the extent of $19,800, defendant in error is richer than she was on March 1, 1913, and this increase in wealth is actually and in truth a gain which she has derived from capital.* And since the income which Congress may tax consists of "the gain derived from capital, from labor, or from both combined", this is the fundamental and controlling fact in the case. (*Stratton's Independence* v. *Howbert*, 231 U. S. 399, 415; *Doyle* v. *Mitchell*, 247 U. S. 183, 185.)

**Defendant in error's gains, received in the form of additional shares of stock, were properly taxed as income unless Congress either is without the power or has not expressed the purpose to tax this particular species of gains.**

Since there is no denying the fact that defendant in error has derived, from her capital, gains which she has received in the form of additional shares of stock, and since, in general, all gains derived from capital are taxable as income, it follows that she was properly taxed, unless it can be said that Congress either has not the *power* to tax such gains in this form or has not expressed a *purpose* to do so.

**The ultimate object of corporate business is gain to the stockholders. This gain always and necessarily first appears in the shape of undivided profits which are held in trust for the stockholders. When, later, dividends are declared, the cash or stock received by a stockholder is the same gain converted into a concrete form for the convenient payment, transfer, or definite assignment to him of his share of the previously undivided profits.**

The relation of a stockholder to the corporation and to its assets is well understood. The money invested in corporate stock becomes, it is true, the property of the corporation, and the investor ceases to own or control it, save as he may exert an influence over corporate management. Instead of being the owner of so much money, he becomes the *legal* owner of a corresponding amount of corporate stock and thereby the *equitable* owner of an aliquot part of the net wealth of the corporation. The business, however, is the business of the stockholders, though, through the machinery of corporate organization, conducted for them by trustees. Its ultimate object is gain to the stockholders. The invested capital of the stockholder is none the less his because held in trust for him by the corporation. And when, from the use of his capital so held, profits accrue, they are his in the same sense. (*Lynch* v. *Turrish*, 247 U. S. 221, 228; *Collector* v. *Hubbard*, 12 Wall. 1.)

A stockholder can derive gain from his investment only through the earning of profits by the corporation. And it is equally impossible for the corporation to

earn net profits without conferring a benefit, a gain, upon him. Whatever technical and legal distinctions may be attempted, as language is ordinarily understood, a stockholder *gains* whenever earnings or profits accrue to a corporation. This gain is precisely the same in whatever form his aliquot part of earnings and profits reaches him or is held for him. It necessarily is either held for him or reaches him in one of three forms:

1. It may be held for him by the corporation as undivided profits, when it will manifest itself in the increased value of his stock.

2. It may be paid to him in money or property as a dividend.

3. It may be transferred or assigned to him in stock issued as a dividend.

Undivided profits are the form which a stockholder's gains derived from corporate earnings first assume. There can be no dividends until there have first been undivided profits. Dividends are merely the form which the corporation causes these gains or undivided profits to assume to facilitate their convenient transfer to those for whom they have been earned. Defendant in error agrees that such gains, when paid in cash or property, are taxable income, says there is a "serious question" as to whether they can be treated as stockholder's income while undivided, and thinks there is some magic in stock dividends which entirely removes them from the realm of the taxing power.

The power to tax such gains, when distributed in cash, being admitted, the only inquiry is as to the power to tax these same gains while held in trust for the stockholder as undivided profits or when transferred or assigned to him in the form of additional stock.

**The power of Congress to tax, as stockholder's income, shares of undivided corporate profits has long been a closed question in this court.**

The brief for defendant in error does little more than suggest a *doubt* as to the power to tax, as stockholder's income, shares of undivided corporate profits. And this court has apparently never entertained the slightest doubt on that subject. It held years ago that the power did exist, and, both before and after the Pollock case, has consistently recognized the soundness of that holding. (*The Collector* v. *Hubbard*, 12 Wall., 1, 17; *Bailey* v. *Railroad*, 22 Wall., 604, 635, 636; *Southern Pacific Co.* v. *Lowe*, 247 U. S., 330, 336; *Lynch* v. *Turrish*, 247 U. S., 221, 228; *Lynch* v. *Hornby*, 247 U. S., 339, 343.)

This question of power is discussed in the original brief for the Government at pages 8–14, and further discussion is not now deemed necessary.

Clearly, it must be regarded as settled that a stockholder's share in the undivided earnings and profits of a corporation is within the power of Congress to tax as a part of his income.

**Equally with cash dividends, and in every essential sense, stock received as a dividend is merely one of the concrete forms in which a stockholder receives gains previously held in trust for him as undivided profits, and is income within the taxing power.**

The right to tax gains derived from a corporate investment when distributed by a cash dividend being admitted, and the right to tax shares in them while held by the corporation as undivided profits having been settled by this court, there can be, it is submitted, no sound reason for saying that stock dividends, the only other form which it is possible for such gains to assume, are excluded from the same taxing power.

1. The Government is under no delusions as to the nature of a stock dividend, or as to what it accomplishes. It serves to readjust the evidence of ownership by which the stockholder previously held his share of both capital and undivided profits. His share of profits are invested for him in the stock of the company. The profits are segregated from his former capital and he has a separate certificate representing his invested profits or gains. It is, of course, conceded that this transaction does not, of itself, make the stockholder richer than he was before. The Government readily agrees that there has been a mere change in form of that which already belonged to the stockholder and that what was not income before is not income after a stock dividend. But this contention of defendant in error proves too much and destroys her case. Her share of undivided profits which has,

by undergoing a mere change of form, become 198 shares of stock, was itself *income* within the power of Congress to tax. Unless its *change of form* destroyed its previous character it was still income. It is defendant in error and not the Government who must rely upon the change of form for success in this case. The Government claims the right to tax gains when wearing a new dress only when they were taxable in their old dress. The defendant in error's contention can not succeed unless the new dress destroys the power to tax which existed before it was put on.

2. Any thing of value, when it represents an actual gain, is income and nothing is income which does not represent a gain. Indeed there is no concrete thing which is always and for all purposes *capital* or always *income*. There is nothing of value which can not be either capital or income according as it does or does not represent or measure a gain. Money is capital and property is invested capital. Money or property when received as a gain is income. Immediately upon its receipt it becomes the capital of him who receives it. What defendant in error actually received was 198 shares of valuable stock. It became, of course, a part of her capital. But the question is, did she derive this addition to her capital from capital previously invested?

3. Defendant in error has undeniably derived gains from her investment in corporate stocks. She has received these gains in the shape of 198 shares of valuable stock. These shares have the same value

they would have had if purchased in the market. If another corporation should purchase them and distribute them among its own stockholders, they would be income of those receiving them. (*Peabody* v. *Eisner*, 247 U. S. 347.) The principle is precisely the same when the corporation invests its earnings in shares of its own stock and distributes these among its stockholders.

4. The *mere* receipt of money or property does not stamp it as income. Whether it is income or not can not be determined without an inquiry into the source from which it has been derived. It may be received as a mere conversion of property from one form to another, and, so far from being a gain of any kind, may involve an actual loss. In other words, what is accomplished by such receipt may be the realization of gains previously accrued, or it may be a return of capital. In any case, when money or property reaches him who receives it, it is immediately a part of his capital. But whether this part of his capital is taxable income depends entirely upon whether it has come to him as the measure of the earnings of his capital or his labor. The question is always, how did he get it?

5. There is no magic in the word *dividend* which makes it, or the money or stock issued under it, any more than money or property acquired in other ways, always and for all purposes, "in its nature," either income or a return of capital. If *money* is paid as the result of a dividend or the distribution of corporate assets it may or may not

be income. If the dividend has been resorted to for the purpose of distributing assets, including no profits, upon the winding up of the corporation, or for the purpose of returning to stockholders a portion of their capital upon an authorized reduction of the capital, the money received by stockholders is not income. (*Lynch* v. *Turrish*, 247 U. S. 221.) But where the purpose and effect is to distribute or assign to stockholders earnings or profits, that which is received by stockholders, whether in money or its equivalent in property, such as stocks of other corporations, is income. (*Lynch* v. *Hornby*, 247 U. S. 339; *Peabody* v. *Eisner*, 247 U. S. 347.) When money received as dividends, therefore, is income, it is not because it is money nor yet because it is paid as a dividend, but solely because it has come to the stockholder as the earnings of his capital, because it serves to transfer or assign to him his share of corporate earnings, and not merely to return some part of his capital.

6. So far as what they serve to transfer or assign to stockholders is concerned, there are but two points of difference between cash dividends and stock dividends.

By a *cash* dividend, a corporation transfers to a stockholder his share of corporate earnings in money, while, in the case of a *stock* dividend, it first invests the earnings in its business and then issues to each stockholder new shares of stock of the same par value as his share of the earnings or, to use other words, invests each stockholder's share of the

earnings in its own stock at par and delivers to him the stock so purchased. In either case, he simply gets, in a concrete form, the actual gains he has derived from his invested capital.

The other point of difference is that a *cash* dividend may serve either to distribute profits or return capital. A *stock* dividend, on the other hand, never contemplates a *reduction* in capital but, on the contrary, necessarily implies an *increase* in capital to be represented by the new shares. It can never, therefore, serve to return capital but that which, in the form of new stock, it assigns to each stockholder is always a share of corporate earnings or gains. In other words, a *cash* dividend may or may not distribute gains, but a *stock* dividend can not, under any circumstances, distribute, assign, or transfer anything else. A *cash* dividend distributes sometimes gains and sometimes capital. A bona fide *stock* dividend always distributes gains.

If the constitutional power exists to tax corporate earnings when they are passed to the stockholder by means of a *cash* dividend, no reason is perceived why the same power does not exist to tax the same earnings when they are passed to him, in an equally concrete form, by means of a *stock* dividend.

Stock issued as a dividend is property in every sense that any other thing of value is property. It is property which has been received by a stockholder. The same test that would be applicable to any other species of property received must be applied. To illustrate, Mrs. Macomber has 198 shares of Standard

Oil Company stock which she received as her property, in 1916. From this statement it does not appear whether they constituted a part of her income for that year. If she had bought them in the market, they would clearly have *not* been income. She would merely have converted her cash capital into invested capital, and there would have been no gain. If she had received them as compensation for personal services or in payment of the rental of property, just as clearly they *would be* income, because they would represent the gain derived from her labor or her capital. If she had received them in repayment of a loan previously made which, with accumulated interest, was equal to their value, they would be income only to the extent of the interest so paid. So far as they were received in payment of principal they would be a mere return of capital. So far as they paid interest they would represent a gain derived from capital. All that Mrs. Macomber, in fact, did to acquire these shares was to invest a part of her capital in the stock of the corporation and thereby to turn over to the corporation that much of her money to use for her benefit. She still has her original stock and it is possessed of a value no less than when she acquired it. But she also has 198 new shares. For these she has paid nothing. To acquire them *she* has not labored but *her capital* has. They are hers because the corporation has caused her money to earn $19,800. If the dividend had been paid in cash, she would have had her original stock, undiminished in value, plus $19,800. That sum

would clearly be her gain. As it is, she has her original stock, undiminished in value, plus 198 shares of stock worth $19,800. The same sum still unerringly measures her gain.

8. If an actual taxable gain accrues, it continues to be no less a gain although it may assume a new form or wear a new dress. And it is submitted, with the greatest confidence, that Congress has the clear *power* to treat as income of a stockholder, stock received by way of dividends.

**The act of 1916 taxes gains derived from capital invested in corporate stocks, that is, shares of corporate gains or profits. It does not tax dividends per se but merely uses them to indicate the form in which such gains shall be taxed and to mark the time when the tax shall be collected. And, in the case of stock dividends, it uses the stock issued to measure the amount of the gains.**

Assuming the *power* of Congress to tax shares of corporate earnings in any of the three forms in which such shares may reach or be held for the stockholder, the next inquiry is whether the tax imposed has been imposed on shares of corporate earnings or upon something else. An examination of the act of 1916 leaves no room for doubt that the subject of taxation which Congress had in mind was *gains derived from investments in corporate earnings accruing after March 1, 1913.*

1. A corporation and its stockholders are separate legal entities. The relation between them is analogous to that of trustee and *cestui que trust* or principal and agent. The corporation is the trustee or agent

of the stockholder to manage and control his capital for the purpose of gain. The power to deal with the corporation as a legal entity and to tax its earnings, as its income, is, of course, undoubted. And if this should be done the power to tax, as stockholder's income, these same profits, when distributed, would still exist. And if Congress had meant to treat dividends as a distinct source of income rather than as a mere change of form of gains already accrued to the stockholder, there would have been no reason why both taxes should not have been imposed. On the other hand, if Congress, looking beyond mere forms and technicalities, regarded all corporate earnings, whether divided or not, as taxable gains of the stockholder, the natural thing to do was to tax these gains either in the hands of the stockholder or in the hands of his trustee or agent, but not in the hands of both. And this is exactly what was done.

A normal tax of 2 per cent was levied on incomes of *individuals* and a like tax upon incomes of *corporations*. But dividends received by individuals from corporations which had paid the tax were excluded from their taxable income. The stockholder received his gains after his trustee had paid the tax and hence was not required to pay it again. This was a simple plan by which the Government collected from a single source and in a single sum the taxes of all the stockholders on their gains. But for the purposes of the additional tax the plan would not work without injustice. That tax was intended to reach large and not small incomes. Congress thought it should not

be imposed on incomes of less than $20,000 and it was not the intention that such incomes should bear the additional burden, as they would be compelled to do if the tax should be laid on the income of stockholders in the hands of their trustee, the corporation. On the other hand, some stockholders enjoy incomes very much in excess of $20,000. The tax they were required to pay ranged from 1 per cent to 13 per cent according to the amount of income. It would, therefore, be impossible to fix a rate of taxation on the income of corporations without taxing one class of incomes which it was not desired to tax and taxing other classes more heavily than was thought proper, or else relieving still another class of a large part of the burden it was intended they should bear. Congress, therefore, did not impose the additional tax on *corporations* at all, but since the stockholder's trustee paid no tax on his earnings, the individual was required to include in his income all gains from corporate investments.

Congress, by thus taxing corporate earnings only once but taxing them as income of either the corporation or the stockholders, as convenience dictated, has in the clearest manner evinced the purpose to treat, as the actual and ultimate subject of taxation, *corporate gains regardless of the form they may assume.*

2. The same purpose runs through the entire act. The tax is levied upon net income derived from "all sources" which, as has been seen, includes shares of corporate profits, divided or undivided. And, in defining net income, for the purpose of the additional

tax, it is provided that income derived from "dividends on capital stock or from the net earnings of corporations" shall not be included. But dividends themselves are derived from and made possible by earnings. The clear implication is that all gains derived from the *net earnings of a corporation shall be taxed.*

3. The purpose to impose the additional tax on all corporate earnings, except such as the reasonable needs of the business require to be kept undivided, is manifest. They are taxed not only when distributed but equally when permitted to accumulate beyond the needs of the business.

4. The act does not say that *dividends* shall be included as income but only that "gains, profits, and income" *derived from dividends* shall be so included. In like manner, "gains, profits, and income" *derived from salaries, wages, interest, and rent* are included. It is the *gains* which are taxed. What is received by way of salaries or wages is income because, through the payment of wages or salaries, it is a gain derived from labor. What is received by way of interest or rent is income because, through the payment of interest or rent, a gain derived from capital has been realized. Money or stock received by way of dividends is income because, through the declaration of dividends, gains derived from capital are received in concrete form.

To say that this is a tax on stock dividends *per se* would seem to be a play upon words. It is a tax on shares of corporate gains, and stock dividends are

used only to indicate one of the forms in which such gains shall be taxed, to mark the time when the tax shall be collected, and to measure the taxable value.

**The tax is not laid annually on a stockholder's share of corporate earnings as they accrue. This species of gains is taxed when distributed by means of a cash or stock dividend, and then the tax for a single year is laid on all such gains so distributed, provided they have accrued since March 1, 1913. The taxable period for corporate earnings, therefore, begins with March 1, 1913, and ends with the declaration of a dividend.**

Commenting on a statement in the Government's brief that stock dividends are income whenever they, in fact, represent an actual gain to the stockholder during the *taxable period*, counsel have said:

> The Government seems to think that because the sixteenth amendment went into effect March 1, 1913, or shortly before that, any succeeding period of years is "the taxable period".

It is then asserted that both the act of 1913 and that of 1916 have their distinct and separate taxable periods, each calendar year being such a period. From this it is argued that whatever remains of undivided profits at the end of each year becomes capital and can not be treated as income accruing or received in any succeeding year.

This argument wholly misconceives the meaning both of the Government's contention and of the acts of Congress. If Congress had levied an annual tax on the stockholder's share of corporate profits *accruing during each year*, then, of course, no one would say that any part of the profits accruing

during a particular year could be carried forward and treated as income of a succeeding year. But that is not this case. An annual tax is imposed on *net incomes received.* But this tax is not permitted to attach *annually* to undivided corporate profits. On the contrary, although *accruing,* Congress refrains from taxing them until *distributed,* or, in other words, treats no part of them as *received,* within the meaning of the act, until there has been a distribution. The result is that, instead of an *annual tax on accruing profits,* we have a *single tax on accumulated profits* levied when they are distributed. As a tax could not have been levied, without apportionment, on such accruing profits prior to March 1, 1913, Congress evidently felt that profits accrued before that date ought not, even if they could, be taxed directly or indirectly when afterwards distributed. It, therefore, limited the tax to dividends declared out of earnings accruing subsequent to that date. The result is that the taxable period for such gains as are received in the form of dividends begins with March 1, 1913, and ends with the receipt by the stockholder of the dividend.

**The substance of the act of 1916 is that no corporate earnings are taxed as distributed gains which might not have been taxed as undivided profits when they accrued, and all such earnings which might have been taxed as undivided profits are taxed when distributed.**

It is, of course, conceded that prior to the effective date of the sixteenth amendment, about March 1, 1913, a stockholder's share of undivided earnings

of a corporation could not be taxed without apportionment among the States. And it is likewise conceded that such earnings as had accrued before that date could not, as undivided profits, afterwards be taxed as stockholder's income.

The act of 1913 taxed income derived from "dividends" but did not define dividends or make their taxability depend upon the time when the earnings accrued. Under that act it was held that taxable dividends were only such as served to *distribute profits* as distinguished from merely *returning* capital, but that the nature of dividends which did distribute profits in money or property was such that they could be treated as distinct items of income without regard to whether the earnings accrued before or after March 1, 1913. It was also decided that the nature of stock dividends was not such that they could, of themselves, be treated as a distinct item of income, and hence that they could not be taxed when declared out of earnings accruing before March 1, 1913. What this court has not had occasion to decide is whether, under the act of 1913, stock dividends, though not themselves distinct items of income, were nevertheless taxable when they served to distribute earnings which accrued after March 1, 1913, and which were, therefore, themselves within the taxing power of Congress.

The act of 1916 puts a different aspect on the question. It defines dividends as including both cash and stock dividends but only when they are declared out of earnings which have accrued since March 1,

2. An assurance that a declaration of dividends would in the future specifically take account of this surplus and be declared upon it.

3. A muniment of title which enables the stockholder to deal easily with his interest in the surplus by a mere assignment of his new stock. (245 U. S. 422-423.)

These were the specific grounds upon which the right to treat stock dividends as income was rested, for, after enumerating them, the Solicitor General said:

> These advantages constitute "income" to the stockholder because they flow to him from his property rights (i. e., "capital") in the corporation, and are capable of easy, accurate monetary appraisement. (Id.)

And further pressing the argument:

> It can not be said that the corporation lost nothing or that the stockholder gained nothing. The former lost its plenary control over the surplus; instead of being indebted to "surplus," with a consequent free use of such funds, it became indebted to "capital," with a limited use of the funds. The latter gained direct right against the corporation instead of an indirect interest in the "surplus." (Id.)

The controversy was thus narrowed to the single question, whether there was anything in the nature of a stock dividend which, without more, made it income, that is whether the mere declaration of a stock dividend conferred such advantages upon the stockholder as to render the dividend an item of

taxable income. Obviously, the court so understood, for, in the opinion, it was to this question alone that Mr. Justice Holmes addressed himself. Viewed in this light, nothing that was said militates against the Government's contention in the present case. It was said that:

> We can not doubt that the dividend was capital as well for the purposes of the Income-Tax Law as for distribution between tenant for life and remainderman. What was said by this court upon the latter question is equally true for the former. (245 U. S. 426.)

It will be observed that it was not said that *no stock* dividend can be income, but only that "the" dividend (that is, the one before the court which distributed profits accruing before January 1, 1913) was capital as well for purposes of taxation as for distribution between life tenant and remainderman. As applied to a case in which the right to tax depends upon the *mere declaration of the dividend* and not upon any facts standing behind that act, no fault can be found with this or with the statement quoted from *Gibbons* v. *Mahon*, 136 U. S. 549, 559:

> A stock dividend really takes nothing from the property of the corporation, and adds nothing to the interests of the shareholders. Its property is not diminished, and their interests are not increased * * * and the proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original shares together

Under that act, the Government comes with this case and asks that a stock dividend declared out of earnings accrued since March 1, 1913, be included as a part of the taxable income of the stockholder receiving it, and in support of its claim says:

> 1. The law does not tax dividends of any kind because they are dividends, but only because they are, in convenient concrete form, gains which have, in fact accrued to the stockholder from capital and mark the time or stage at which Congress has enacted shares of corporate profits shall be taxable.
>
> 2. The purpose to lay the tax directly upon shares of corporate profits is obvious from the fact that, in different contingencies, it is to attach to every form in which it is possible for such profits to inure to the benefit of the stockholder, namely, undivided profits, ordinary or cash dividends, and stock dividends.
>
> 3. The tax on shares of corporate profits is levied upon condition that one of three things shall happen to them, namely, that (*a*) they shall be permitted to accumulate to evade the tax, (*b*) they shall be distributed by means of a cash dividend, or (*c*) they shall be transferred or assigned to stockholders by means of a stock dividend.

Since the power to tax shares of corporate profits, divided or undivided, can not be successfully challenged, these positions, in no way, conflict with *Towne* v. *Eisner*, are supported by reason and authority, and fully justify the tax claimed in this case. Indeed, the defendant in error now, in effect,

takes the same position which the Government took and the court rejected in *Towne* v. *Eisner*. Dealing with gains which had accrued before March 1, 1913, and hence were not taxable as undivided profits, the Government endeavored unsuccessfully to maintain that there was something in the nature of a stock dividend which could convert nontaxable capital into taxable gains. Dealing now with gains which were taxable as undivided profits, defendant in error is forced to contend that there is something in the nature of stock dividends which can convert taxable gains into nontaxable capital. The Government failed because a stock dividend is a mere change of form and does not affect the taxability of that whose form it changes. The defendant in error must fail for the same reason.

**When a stock dividend is declared the stockholder realizes on his gains just as substantially and in the same way as when a cash dividend is declared and, as is frequently done, he immediately uses the money received to purchase new stock issued by the company.**

There can scarcely be any difference in principle between this and the case in which stockholders use the money received as cash dividends to purchase of the corporation additional stock. In the latter case, the tax is not imposed on the new stock but on the money which represents a share in corporate earnings. In the former case, the stock issued in payment of a stock dividend is not taxed as such. It merely furnishes evidence of the value of a share in corporate earnings which is taxed.

The identity, in principle, of the two cases is well illustrated by the method resorted to sometimes for accomplishing the same purposes that are accomplished by declaring stock dividends. In Missouri and some other States, and under the National Banking laws, statutory provisions are construed to prevent the issuance of stock in payment of dividends. In those States the same result is obtained by the corporation declaring and paying a cash dividend and the stockholders, having previously subscribed for the new stock, paying for it with the money received as dividends. Can it be supposed, for a moment, that the stockholder, in one State, who has received a stock dividend has, in fact, *gained* any less than a stockholder, in another State, who has received a dividend of the same amount in cash and immediately used it, pursuant to a previous agreement, to acquire additional stock?

**Reply to arguments on behalf of defendant in error.**

It is believed that a complete answer to the arguments advanced on behalf of defendant in error is to be found in what has already been said. But a more specific reply to some of these arguments will now be attempted.

**A stock dividend, while it does not cause the corporation to part with any of its assets, does segregate the stockholder's share of profits from his capital and gives him something of value which is derived from his invested capital.**

The argument of counsel seems to be based on the idea that there can be no income to the stockholder unless and until the corporation parts with some of

its assets. But the question is not whether the corporation has lost anything, but whether the stockholder has gained anything? When he receives a cash dividend the money is income, not because the corporation has parted with it and not merely because he has received it but because he has received it *as the fruit of an investment* previously made. It is taxed because Congress has enacted that his share of corporate profits shall be taxed when it is segregated *in this way*. The important fact is not a segregation from the corporation of some of its assets but, if a segregation of any kind is necessary, it must be of the stockholder's *gains* from his capital. Congress has now, however, by the act of 1916, enacted that the tax shall be collected when the segregation is accomplished by means of a stock dividend. And this is a real segregation. Before a dividend, one certificate is the evidence of a stockholder's ownership of a share of capital and also a share of profits. When he receives a cash dividend the value of his certificate is reduced and the money received measures the gain which his investment has yielded. When he receives a stock dividend, the par value of his *new* certificate measures his *gains*. As the fruit or result of his investment something of value which is distinct from his original capital and distinct from the corporation's ownership of its assets has come to him. And, as applied to the present case, it may be said that there is no very substantial difference between Standard Oil stock and cash.

**The fact that a stockholder is no richer immediately after than immediately before a stock dividend is wholly unimportant.**

Counsel for defendant in error assert that the fundamental fact is that a stockholder is no richer after than before a dividend. The fact is admitted but its importance is denied. On a given day one owns a certificate of stock which evidences his ownership of an aliquot part of the capital stock plus the same aliquot part of undivided profits amounting to 50 per cent of the capital. The next day, by virtue of a 50 per cent stock dividend, he owns two certificates, which, however, together evidence his ownership of the very same capital and profits. Of course, no one would say that he has, in the meantime, become richer. But neither has one become richer who one day owns a share of stock which, with its accumulated profits, is worth $150, and, on the next day, by virtue of a cash dividend, owns a share of stock worth $100 and has $50 in cash.

The important fact is that, assuming that the 50 per cent profits have been earned since March 1, 1913, he has, in either case, become richer since that date through the earnings of his invested capital. Congress has seen fit to say that these earnings may accumulate free from tax until they are delivered to him either as cash or in stock. His gain comes, not from the declaration of a dividend of any kind, but from what his capital has earned. The only effect of the dividend is to fix the date upon which, under the law, his share of corporate earnings, previously accrued, becomes taxable.

**What was held in Lynch v. Hornby and Towne v. Eisner does not conflict with the present contention that the tax of 1916 is laid on corporate earnings in the form of dividends and not merely on dividends per se.**

It is said that the divergent opinions in *Lynch* v. *Hornby* and *Towne* v. *Eisner* show that the tax is laid upon dividends *per se* and refute the present contention that the tax is laid upon corporate earnings and that dividends have been selected as a convenient form in which to reach such earnings.

In both of those cases, it was true that the earnings distributed were beyond the power of Congress to tax. It may be said then that *Lynch* v. *Hornby* does hold that, under the act of 1913, *cash* dividends *per se* were taxed. This was because that act contained nothing which limited the tax to dividends declared out of *taxable* profits. But certainly nothing was said which implied a want of power in Congress to impose a tax only on all dividends of whatever kind which, in fact, serve to distribute profits which it *might have taxed while undistributed*, and this, as has been seen, is exactly what the act of 1916 does.

**If not included under the term "dividend," stock dividends were excluded from taxation by the act of 1913.**

It is said, in effect, that *Towne* v. *Eisner* must be regarded as determining that a stock dividend, in its very nature, can never be treated as income, for otherwise such dividends were taxed by the act of 1913 which embraced "the entire net income arising or accruing from all sources." This language was

used to express the general purpose of the act. It was followed, however, by other language prescribing the manner in which different species of income were to be reported and taxed. A stockholder's share of corporate profits was not required to be reported, unless such profits had been permitted to fraudulently accumulate, until it reaches him in the form of a "dividend." The purpose to exclude from taxation corporate earnings save in one of these two forms was obvious. When, therefore, it was held that stock dividends were not "dividends" within the meaning of the act, the result was that stock issued as dividends merely represented undivided profits, which Congress refrained from taxing, held by a different title and evidenced in a different way. Manifestly, being clearly excluded from the purpose of Congress to tax, they could not have been held to be included in the general language quoted.

**As to the taxability of undivided profits, the present case involves no consideration which was not equally involved in Collector v. Hubbard.**

Counsel have quoted from the opinion in *Collector* v. *Hubbard* as follows:

> Annual gains and profits, whether divided or not, are property, and, therefore, are taxable.

The argument seems to be that the case turned on the fact that this interest of the stockholders was *property* rather than that it was *income*. The implication is that the court then thought that Congress

had power to levy direct taxes on *personal property* without apportionment and hence, having found that the thing taxed was personal property, did not find it necessary to pursue the inquiry further. But the tax under consideration was, in form and in fact, an income tax and the thing taxed was a share in corporate earnings. The case must, in any view, be authority for the proposition that *property*, such as a share of undivided corporate profits, might be taxed along with income by an act which purported to tax only income. One of two propositions must follow:

1. Such share of undivided profits was held to be income to stockholders as the profits accrued, or

2. Though not income, Congress, having the power to tax it as property, might, under that power, tax it along with income and by an act which purported to tax nothing but income.

The first proposition would be conclusive of the case. The second would sustain the tax as an excise tax on the privilege of receiving dividends even though it could not be sustained as an income tax.

**The tax is imposed upon shares of corporate earnings, divided or undivided, and the various forms, including stock dividends, in which they shall be taxable, are specified. It is, therefore, immaterial whether such a dividend be regarded as distributing profits or only readjusting the evidence of their ownership.**

An elaborate argument has been indulged to show that the tax in question is not one on *undivided profits*. This, however, is beside the question. It

may be more accurate to speak of a stock dividend as readjusting the evidence of ownership of undivided profits rather than as distributing such profits. But, by specifying the various forms in which corporate earnings shall be taxable, the act clearly expresses the purpose to tax them, *divided or undivided*, according to circumstances. When a stock dividend has been declared, they have either been divided or, of necessity, they remain undivided, though held by a different title. In either event, they have assumed one of the forms in which Congress has said that they shall be taxable.

**If any unfairness results from the Government's construction of the law, it is much less than would result from that urged by defendant in error.**

It is stated that the Government's construction of the law imputes to Congress the intent to perpetrate a gross inequity. It may be replied that it is impossible to frame any general tax law in which inequalities can not be found. Moreover, what is called a gross inequity, when examined, does not seem so very gross. It is true that a stockholder who has stock of the par value of $1,000 which carries with it a share of undivided profits worth $100 is no richer and has gained no more than another who owns stock of the same par value but has received his profits in the shape of a stock certificate for $100. The suggestion is that it is unjust to tax one and not the other. But no corporation is compelled to declare stock dividends. It is only done when supposed to be, for some reason, an advantage to stockholders.

Otherwise, such part of the profits as it is not thought proper to distribute in cash would be left undivided. If there appears to be enough advantage to stockholders in having their profits in additional stock to justify paying the tax, the corporation may declare a stock dividend; if not, it is at liberty to keep the profits undivided. It is difficult to see any glaring injustice in this. Certainly there is no such injustice as would result from taxing cash dividends and not taxing stock dividends. In that event, one receiving $1,000 in cash would pay a tax, while one who received a stock certificate which could be immediately converted into $1,000 would go free.

The general plan seems to be a fair one. None are required to treat as income corporate earnings so long as they remain undisturbed in the hands of the corporation. Those who receive them from the corporation in cash or stock, in money or invested capital, must treat as income the value of what they receive.

By not imposing an annual tax on accruing corporate profits, Congress has not withdrawn for all time the hand that gathers taxes from such profits accruing during a particular year. It has merely stayed that hand until the happening of a named contingency—a distribution of accumulated profits.

**Conclusion.**

It is clear that Congress has the power to tax, against stockholders, shares of corporate profits when they take the form of stock dividends; that the pur-

pose to do this has been expressed in unmistakable language; that the tax now in question is clearly within the terms of the law; and that the judgment of the district court denying the Government's right to collect it should be reversed.

Respectfully,

WILLIAM L. FRIERSON,
*Assistant Attorney General.*

SEPTEMBER, 1919.

○

FILED
OCT 13 1919
JAMES D. MAHER,
CLERK

No. 318

IN THE

# Supreme Court of the United States

OCTOBER TERM, A. D. 1919.

MARK EISNER, COLLECTOR, ETC.,
*Plaintiff-in-Error,*

*against*

MYRTLE H. MACOMBER,
*Defendant-in-Error.*

IN ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF NEW YORK.

## Motion for Leave to File a Brief and Argument, and Brief of Argument of George W. Wickersham and Charles Robinson Smith as *Amici Curiae* in Support of Judgment Below.

GEORGE W. WICKERSHAM,
CHARLES ROBINSON SMITH,
*as Amici Curiae.*

The Dispatch Printery & Bindery Corporation
New York

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IN THE

# Supreme Court of the United States,

OCTOBER TERM, A. D. 1919.

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No. 318.

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MARK EISNER, COLLECTOR OF UNITED STATES INTERNAL REVENUE FOR THE THIRD DISTRICT OF THE STATE OF NEW YORK,

PLAINTIFF-IN-ERROR,

AGAINST

MYRTLE H. MACOMBER,

DEFENDANT-IN-ERROR.

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IN ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF NEW YORK.

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**Motion for Leave to File a Brief and Argument, and Brief of Argument of George W. Wickersham and Charles Robinson Smith as Amici Curiae in Support of Judgment Below.**

## Motion.

Now come George W. Wickersham and Charles Robinson Smith, attorneys and counsellors of this Court, and represent that there is involved in the above mentioned case a question of whether or not,

under the Sixteenth Amendment of the Constitution of the United States, Congress is empowered to impose an income tax upon stock dividends of a corporation issued with respect of profits of such corporation accumulated since March 1st, 1913, upon the issue of such stock dividends and before sale thereof by the stockholder;

That this is a question which vitally affects the interests of a number of their clients who would be adversely affected by a decision affirming the position taken by the Government in this case.

Therefore, they pray leave to file a brief and argument as *amici curiae* in support of the affirmance of the judgment of the Court below; such brief and argument being as follows:

## Statement.

The facts are set forth in the statement of the case in the Brief and Argument for defendant-in-error, submitted by the Honorable CHARLES E. HUGHES and GEORGE WELWOOD MURRAY.

## BRIEF OF ARGUMENT.

The Government seeks to distinguish this case from the decision in *Towne* v. *Eisner,* 245 U. S., 418, upon the ground that the stock dividends there under consideration were issued with respect of profits of the corporation earned and accumulated prior to March 1, 1913, whereas here the tax was levied upon an amount of the stock dividend equal at par value to the aggregate accrued profits of the corporation earned since March 1, 1913. The argument is, that all earnings of a corporation constitute income belonging to or held in trust for its stockholders, and are subject to the constitutional

power to tax incomes, which may be exercised as Congress shall elect, by imposing the tax wholly or in part upon the corporation, or wholly or in part upon the stockholders.

This argument brushes aside the separate corporate entity, treats corporate enterprise as a mere partnership, and thus establishes the plenary authority of the taxing power over the aggregate corporate gains, irrespective of whether or not the stockholders actually may have received or enjoyed any share in them. It is claimed that this position is supported by the decision of this Court in *Collector* v. *Hubbard,* 12 Wall., 1.

The Act of Congress of 1916 (39 Stat., 756, Sec. 2a), in imposing an annual tax upon the net income of a taxable person derived, *i. a.,* from dividends, provides that the term "dividends", as used in the act,

> "shall be held to mean any distribution made or ordered to be made by a corporation * * * out of its earnings or profits accrued since March first, nineteen hundred and thirteen, and payable to its shareholders, whether in cash or in stock of the corporation * * *, which stock dividend shall be considered income, to the amount of its cash value."

To bring a dividend within this definition, it must appear

(1) that the corporation has made or ordered a *distribution* out of its earnings or profits accrued since March 1, 1913;

(2) that such *distribution* is made payable to its stockholders, including the person taxed;

(3) that such *distribution* is payable in cash or in stock which has a cash value.

But a stock dividend, pure and simple, such as that made by the Standard Oil Company of California in the instant case, is not a *distribution* of anything. It is a mere *readjustment* of the evidences of the shareholders' interest in the corporation. The issue of certificates for shares under these circumstances is not *payment* of any earnings or profits. The provisions of the statute are not applicable to such an issue.

The Government concedes the facts, but disputes the conclusion. The Assistant Attorney General in his supplemental brief (at p. 15) says:

> "The government is under no delusions as to the nature of a stock dividend, or as to what it accomplishes. It serves to readjust the evidence of ownership by which the stockholder previously held his share of both capital and undivided profits. * * * The Government readily agrees that there has been a mere change in form of that which already belonged to the stockholder and that what was not income before is not income after a stock dividend."

It is sought to avoid the effect of this concession by the argument; that the income of *the corporation* is also the income of the stockholder; that the issue of a stock dividend distributes that income to the stockholder and that the government, which could tax the income as it accrues either against the corporation or the stockholder, acts within its powers and exercises them with fairness and restraint, when it only imposes the tax at the moment when the stockholder receives a separate stock certificate representing what the government is pleased to call "his invested profits or gains."

We challenge the soundness of this position. It is contrary alike to economic fact and well settled principles of law. We deny that it finds some sup-

port in *Collector* v. *Hubbard,* 12 Wall., 1, but even if it did, we should deem it immaterial. Since the income tax cases of 1894 (*Pollock* v. *Trust Co.,* 157 U. S., 429; 158 U. S., 601), the authority of that case is restricted to direct taxation of property. Considered in its effect upon income, it is overruled by well settled lines of decision.

Moreover, if the Government is correct in its interpretation of the statute, and Congress did attempt to tax the stockholder as the recipient of an amount of income equal to the cash value of the stock issued, even though the same be issued to represent an amount of corporate gain received and accumulated by it in previous years, upon which the corporation itself paid, or is liable to pay the tax imposed upon it, carrying the balance to the credit of surplus account, adding it to its capital, and investing it in its business; then, we submit, Congress has exceeded the constitutional limit of its powers, and in effect has imposed a direct tax upon capital, without apportionment, which may not be justified by calling the capital income, which it is not.

## POINTS OF OUR ARGUMENT.

**1. The principle laid down by this Court in two well-considered cases (Gibbons v. Mahon, 136 U. S., 549, and Towne v. Eisner, 245 U. S., 418), that stock dividends represent capital and do not constitute income is based on sound economic reasoning.**

**2. Although the Hubbard case (Collector v. Hubbard, 12 Wallace, 1) is plainly distinguishable from the case at bar, it is nevertheless inconsistent both with other and later rulings of this Court and with sound economics. It tends to block the way to a**

consistent, harmonious and logical system of income taxation and it should be expressly overruled.

(a) The Hubbard case as upholding a tax on property or the income from property except by apportionment under Art. I, §2 of the Constitution has been overruled by the Pollock case.

(b) The Hubbard case, insofar as it assumes an equivalency between the property and the income of the corporation and the shares of stock in the names of the stockholders for taxation purposes, has been implicitly overruled by a long series of authorities in this Court.

(c) The suggestion that this Court has in other cases cited Collector v. Hubbard or its principle with approval except upon altogether minor points is erroneous.

3. The stock dividend is in reality not a dividend at all. It is a mere certified expression of an undivided surplus and its capitalization.

Whatsoever gain there may be in either case to the stockholder is a capital gain.

Capital gains (being mere increases in valuation) are not income until realized.

The gains that come with stock dividends when stock is sold are realized capital gains—the same in nature and similarly taxable as those gains that are made with any stock that is sold at an advance. Inasmuch as undivided corporate earnings cannot be taxed as income against the stockholder, so the stock certificates issued with respect of such earnings may not be so taxed, until the gain be realized by the stockholder through sale of his stock.

## FIRST POINT.

**The principle laid down by this Court in two well-considered cases (*Gibbons v. Mahon* and *Towne v. Eisner*), that stock dividends represent capital and do not constitute income is based on sound economic reasoning.**

The question involved here is one of definition—the meaning of the word "income" as used in the Sixteenth Amendment. It is absolutely necessary to define the meaning of that word and its limitations, if the restrictions of the Constitution on the power of taxation are to be respected.

The original provisions of the Constitution as limited by the *Pollock* case and enlarged by the Sixteenth Amendment have now given to Congress definite, broad powers of taxation with definite limitations thereon. It is settled that taxes on land or personal property are direct taxes and cannot be levied except by apportionment. On the other hand, income from whatever source derived, even income from land and personal property, may be taxed by the Federal Government without apportionment.

In applying these powers, it becomes necessary, therefore, to distinguish what is Capital and what is Income. If a stock dividend is taxable under the Revenue Act in question, it must be not because stock dividends are expressly mentioned in this Revenue Act as they are in fact mentioned, but because the term "stock dividends" is really covered by the term "income" in the Sixteenth Amendment—because, in short, stock dividends may be properly defined as income.

Just as a stream cannot rise higher than its source, so the Revenue Act could not include as taxable any items that were not already included in that single word "*Income*" as employed in the Sixteenth Amendment.

Nobody doubts that cash dividends in general are included in this word income. If stock dividends are included, it must be because stock dividends are income. If stock dividends are not dividends, then they certainly are not income. But this Court has twice decided that stock dividends are intrinsically not dividends at all. In *Towne* v. *Eisner*, the Revenue Act of 1913 used language as broad as that of the Sixteenth Amendment. The language of the Sixteenth Amendment is: "Income from whatever source derived." The language of the Act of 1913 is: **"The entire net income arising or accruing from all sources** in preceding calendar year," and yet this Court held that stock dividends were not income within that Act.

In this respect the Court is supported by sound economic reasoning. A consideration of the distinction between Capital and Income will show that this is so; and **as the subject matter of the Sixteenth Amendment was an economic question, it must be assumed in default of plain language to the contrary, that the people in so fundamental a law as a constitutional amendment employed terms in treating it that would be conformable to sound economic principles.**

In a sense, **all capital excepting bare land** was in its origin income. What we now know and recognize as capital was originally wages or salary or profits or rents or interest or return or remuneration of some sort for effort or for the use of previous capital. The whole economic situation is in a state

of flux—a state of change, not a fixed state but a state of becoming, and thus income is continually becoming capital. For purposes of this definition, it is important to fix the time when this occurs, or at least its boundaries, because income that has once become capital can no longer be taxed as income under the Sixteenth Amendment unless we break down all the limitations of the Constitution —all distinction between income and capital—all distinction between income taxes and capital or direct taxes.

There is often no ear-mark to show what items of property or money are income and what capital. A man's wages, his salary, his interest or cash dividends, may be thus ear-marked at the time of their receipt; but in industry, the gross returns indiscriminately include the return or repayment of the capital invested in manufacturing the goods as well as the profits thereon, and in such case a mere adding up of receipts does not show the income of the industry. The greater part of those receipts is capital return. Hence it becomes necessary to keep elaborate accounts and at fixed periods determine that part of the receipts which is the return or restoration of the capital invested in materials and wages, etc., in producing the goods and that part, if any, left over for profits or income. But in either or any case, these returns thus constituting income unless consumed quickly become capital.

**What was the income of one year becomes the capital of the next.** An income tax, therefore, in order to be a real tax on income must as nearly as possible catch that income whilst it is income or as soon thereafter as the amount of income for the given period can be determined. It is obvious that

no one year's income can be known until after the end of that year and in industry it takes days, weeks and sometimes months after the end of the year to compute what has been that year's income. For this reason, much of the year's income thus open to taxation may have become changed into fixed forms of capital before the tax can even be computed or levied; but that is a difficulty inherent in the income tax, and this difficulty only emphasizes the need in a true income tax, of levying the tax as promptly as possible and before the income to be taxed can have been too largely changed in character.

**Time is thus an important element in distinguishing capital from income.**

With a tax law known in advance, there will be no difficulty in reserving from the ebb and flow of the year's income enough to pay each year's taxes as they may be computed shortly thereafter.

**These considerations lead to the conclusion that the income of any one year should be taxed only once and not at two different times—and especially not in two successive years or tax periods.**

To illustrate with a concrete case: We will suppose that a given corporation has paid in 1916 its taxes on all its 1915 income including its surplus for that year. This surplus has become invested in extensions and has then become fixed capital. The corporation gives its stockholders certified proof of this fact by distributing additional shares covering exactly the beneficial interests they had before—no more and no less, certifying however to them the fact that the business has been extended and that some of the Company's income has been made capital. This stock dividend is distributed in 1916 because the earnings of 1915 permitted this capi-

talization of income, but the earnings are 1915 earnings. Now, mark the result. If the stockholder is taxed on this stock dividend, he is in effect made to pay in 1917 as if on 1916 income what was in reality 1915 earnings. And yet, if there be any distinction whatsover between Income and Capital, it is obvious that what was earned as income in 1915 cannot be considered the income of 1916. By that time it has clearly become capital. In this particular case, we have a confirmation that it has become capital, because the fact is so certified to us by this stock dividend which is a way of saying that the company had not the cash to pay a dividend and needed to capitalize these residual profits to extend its business. This certification that income has become capital is certainly not income in itself—no new income. The stockholder is intrinsically no richer the instant after than the instant before the dividend, and the corporation is no poorer, as the Supreme Court several times has said.

**So that the Government's contention amounts to this: That this income earned by the corporation in 1915 and subjected to an income tax as soon thereafter as possible in 1916, may still in 1917 be made to pay another income tax as 1916 income just because in that later year it is certified to the stockholder not as income but as capital.**

Our analysis thus discloses two conclusive reasons why stock dividends are not income. First: that already emphasized by this Court, that they are like undivided profits—the stockholder is no *richer* than before merely by reason of the stock dividend; and secondly, that at the time when the stock dividends were received, they had ceased to be earnings of the taxable year, having already become capital.

The very fact that Congress in this Revenue Act

found it necessary expressly to specify stock dividends proves that they would not be included in the broad te. *"Dividends";* if they are not included in the term *Dividends,* they certainly are not included in the Sixteenth Amendment, for if stock dividends are income, it must be because they are dividends.

**This analysis is in accord with the views and the reasoning of scientific economists.**

"Income and capital are therefore two aspects of wealth. In the one case we measure wealth as a flow of services or a stream of satisfactions; in the other case, as a stock of services or a fund of satisfactions. * * * The original conception of income is therefore pleasure or benefit income" ("Principles of Economics," Seligman, 7th Ed., p. 16).

With this ultimate psychological analysis we have, however, little to do in any scheme of taxation which concerns money or money's worth; and so Prof. Seligman adds: "In modern times value has come to be estimated in terms of money and income is accordingly used in general to denote the inflow or revenue in money—the money income as opposed to the pleasure or benefit income." And again, "Capital is capitalized income" (*Id.*, p. 17).

**The distinction between income and the accumulation of postponed and deferred income that we call capital is the fundamental distinction in economic life.**

"The business man's income means money income" ("The Nature of Capital and Income" by Prof. Irving Fisher, p. 103).

*"Income* as contrasted with capital denotes that amount of wealth which flows in during a definite period and which is *at the disposal of the owner for purposes of consumption, so that in consuming it,*

*his capital remains unimpaired"* (Seligman, Income Tax, p. 19).

(See Prof. Seligman's masterly analysis in an article entitled "Are Stocks Dividends Income?" reprinted from the September, 1919, number of the American Economic Review and accompanying main brief in this case.)

No one would be disposed to dispute, but on the contrary all would accept this Court's definition of income as "the gain derived from capital, from labor, or from both combined". But when the Government undertakes to apply this definition to anything of value in whatever form, however inchoate, unrealized and unseparated, which represents a gain derived from capital, labor, or both, to paper gains in fact, the Government is contradicted both by the previous rulings of this Court and by sound economic reasoning.

If gains in general and paper gains may properly be considered income, then this would hold true of mere appreciation in value of real estate or of personal property that is not sold—a gain that is not realized. But this sort of appreciation or gain in capital value can never constitute income within the Sixteenth Amendment. See *Gray* v. *Darlington*, 15 Wallace, 63; the last sentence in *Lynch* v. *Turrish*, 247 U. S., 221, at p. 231; *Baldwin Locomotive Works* v. *McCoach*, 221 Federal, 59, and *Towne* v. *Eisner* (*supra*).

And if a stockholder holds stock in a corporation which has made large earnings that have not been divided, and on which the corporation has paid its income tax, such stockholder has indeed made an unrealized, an inchoate, capital gain and his stock has probably advanced in market price. This increment is perhaps property which might be taxed as such. But can this unrealized gain in his capital

be considered income and taxable as income within the Sixteenth Amendment by any amount of legislation? Certainly not if the distinction is to be preserved between the corporation as one person and the stockholders as distinct persons; nor if the distinction is to be preserved between a gain which is realized and which produces the money to pay an income tax and one which is unrealized and produces no money.

**It cannot be doubted that the sort of gain referred to by this Court as constituting income was a realized gain—not the gain of mere appreciation in value.**

This appears from an examination of what this Court referred to in the two cases in which it defined the word.

In *Stratton's Independence* v. *Howlett* (231 U. S., 399, 415), the gains thus defined were the profits of a mining company from the mining and sale of coal.

In *Doyle* v. *Mitchell* (247 U. S., 183, 185), the gains in question were the profits from the cutting and sale of timber.

There was evidently nothing inchoate about gains such as those. They were gains that had been realized and "cashed in" and of course they were taxable as income.

This distinction between realized and unrealized gains is of capital importance in the income tax. Unrealized gains are technically inchoate gains and inchoate gains are not income. This does not mean that a gain in capital may not become income. Capital increment becomes income when realized—that is, when cashed; until then, barring a few exceptions alluded to below, it is inchoate. Realized capital increment is income in its widest sense. Unrealized capital increment is not income but

simply an appreciation of capital—no flow of income whatever.

The distinction was well marked by this Court in *Lynch* v. *Hornby* (247 U. S., 339), where it spoke of "accumulated earnings as coming to fruition," and of a *"realization in possession of an inchoate and contingent interest that the stockholder had in a surplus of corporate assets previously existing"* (p. 344).

**The same thought is expressed by Mr. Justice Holmes in Towne v. Eisner where he says: "If the sum, [that is, the same amount as the stock dividend] had been carried from surplus to capital account without a corresponding issue of stock certificates, which there was nothing in the nature of things to prevent, we do not suppose that any one would contend that the plaintiff had received an accession to his income." 245 U.S., at p. 426.**

When we speak of realization, we usually mean a realization in cash. But this is not always so. A lessor of a farm who receives his rent in produce; the farmer who gathers his harvests and holds them unsold beyond the taxable year; the manufacturing company which makes unsually large sales on credit, which sales are not cashed during the taxable year: all these are cases where realized profits and income are clearly made during the taxable year although they be not cashed in.

But all these, like dividends in kind, are new gains separable from the capital which produced them and they are realized in the possession of, and are under the control of, the recipient—and they can be realized in cash by him without in any way affecting his rights in these respective sources of his income.

The Union Pacific stockholder who received B. &

O. shares as a dividend received a new gain separable from his Union Pacific shares—a gain realized in the concrete form of income producing property and realizable in cash by sale thereof without affecting his investment rights in the Union Pacific (*Peabody* v. *Eisner,* 247 U. S., 347).

But if the Union Pacific had given him a stock dividend instead of this dividend in kind, he would have realized no new gain—he would have had nothing intrinsically new to cash that he did not have before—and if he had sold the new stock he would have parted not with a thing separated from the Union Pacific Company but with a percentage of his former interest in that company itself.

**A most important point is the separation of the increment from the capital.**

This separation is necessary in order to constitute income. The increment as separated is income. The increment of capital unseparated is capital—whether it be a corporate surplus or a gain in value. From the shareholder's point of view an increase in the surplus of the corporation is precisely like an appreciation in value of real estate or other property holdings—no more, no less.

In another aspect, this separation of income from capital means giving to the stockholder personally control of something he did not have before. Give him a dividend in cash or in tons of coal or in stocks of other companies than his own and he controls something new—may do with it what he please without affecting his interest in his company. Give him a stock dividend and he neither owns nor controls anything new whatsoever, in an intrinsic sense. And let him but sell his stock dividend and he loses control *pro tanto* of that which he had before. He diminishes his beneficial interest in, and percentage of control of his company.

Not so with a real dividend, be it cash or tons of coal or securities in another company. Let him part with these and his interest in his company, the source of this dividend, remains entirely unaffected.

As Prof Seligman says: "Income is that wealth which flows in during a definite period and *which is at the disposal of the owner for purposes of consumption*" (Seligman, Income Tax, p. 19). The gain must be some new thing at the disposal of the owner or it is not income. To illustrate: after a 25 per cent stock dividend on 100 shares of stock, the stockholder has nothing more and nothing intrinsically different to dispose of than before. In either case by selling one-fifth of his holdings he would part with precisely the same interest in the company and its surplus—lose precisely the same degree of control. And in either case, if he holds his stock he holds the same interest, the same undivided earnings, the same control.

Almost all these points of distinction between gains in general and real income are set forth in that one short sentence cited from *Lynch* v. *Hornby* (*supra*). An undivided corporate surplus as regards the stockholder has not yet "come to fruition"; is not yet "realized"; is not "in possession" as regards him. It is on the contrary "inchoate," and it is "contingent"—because its "coming to fruition," being "realized," or coming into his possession, depends on other wills than his—so that he may never receive it. And as a mattter of fact in most cases never will—for in most cases the surplus will have been capitalized—and the stock dividend is but the formal authentication of that fact.

An undivided corporate surplus, therefore, which the corporation has set aside for extensions and

virtually capitalized, lacks the very essense of income from the stockholder's point of view. It is as little income and as much capital as is the increase in value of one's unsold real estate.

It is believed that no country in the world has ever attempted to tax a shareholder because of an increase in the surplus of a corporation (if exception be made of Chap. 173 of the Laws of 1864, which since the *Pollock* case to be discussed later, would now be deemed unconstitutional—see below).

Whenever a corporation has made substantial earnings, three courses are open to it: It may either declare a cash dividend, or it may merely increase its surplus, or it may distribute a so-called stock dividend.

In the case of the cash dividend, the new increment is a realized gain, separated from the company's assets, and is income. In the case of the increase in surplus, the unrealized gain is not income and no money is furnished to pay an income tax unless some of the stock is sold. In the case of the stock dividend, the new increment is not a realized gain and it is not income and, as in the preceding case, no income is produced to pay an income tax unless some of the stock is sold. "The stock dividend is like an increased surplus—it is not like a cash dividend. In fact, a stock dividend is not a dividend at all in the sense in which a cash dividend is a dividend. The entire confusion really arises from a misnomer." (Seligman's article, *supra*, p. 534).

In the case of the cash dividend, the corporation in the first instance had made its profits on which it is liable to an income tax, and it has taken a part of those profits from its own assets and given them to the stockholder as a realized gain to him on which he too is liable to an income tax.

On the other hand, the case of the undivided surplus and the case of the so-called stock dividend are intrinsically similar, in that what was a gain to the corporation on which it has paid an income tax has become capital; and whether it stands as a surplus or stands as officially capitalized by stock certificates, in neither case is it a realized gain to the stockholder. Nor in either case has the corporation parted with anything.

But, where a dividend is made in kind—that is in property or in shares or securities of another corporation, the company does part with some of its own assets and give its stockholders dominion over them. These assets are not invested as capital in the Company's business; they constitute a real gain to the stockholder over what he had before. And if he sell the items received in order to pay his income tax, he does not part with any interest in or control over his corporation, as he would do if he sold his stock dividend shares. Real dividends transfer to stockholders property which previously belonged to the corporation. Stock dividends do not do this. The situation both of the Company and of the stockholders is intrinsically the same just after, as just before, a stock dividend.

On the former hearing of this case, the Government argued in effect that a stock dividend is similar to a dividend in the stock of another corporation —although this Court had distinctly said the contrary in *Peabody* v. *Eisner,* 247 U. S., 347. "It hardly is necessary to say that this case is not ruled by our decision in *Towne* v. *Eisner,* since the dividend of B. & O. shares was not a stock dividend but a distribution *in specie* of a portion of the assets of the Union Pacific, and is to be governed for all present purposes by the same rule applicable to the distribution of a like value in money" (p. 349).

Of course, the stock dividend like the dividend in kind would affect or reduce the previous book value of outstanding shares of stock; but it would *reduce them by dilution.* The dividend in kind *reduces them by subtraction.* And the stock dividend would not reduce the corporation's assets and it would not increase the stockholder's assets—as would the dividend in kind or in another company's stock or in cash. The stock dividend takes nothing from the company and consequently gives nothing to the stockholder that he did not have before. Not so the dividend in cash or in the stock of another corporation. The corporation here parts with some of its assets. The stockholder becomes *pro tanto* sole owner of these. He has a new power of disposition and a control that he did not have before.

The dividend in kind in the stock of another company if sold involves no parting with assets essential to the original company or still belonging to it, and above all it involves no sacrifice of or change in voting control—no change whatever in the stockholder's investment in the business or in his percentage of future dividends and earnings.

The time may come, however, when the stockholder will realize on his inchoate gains. He may sell his stock. In fact, he is almost certain to do so at some time or another; and when this happens, the increased value imparted to his total holdings, whether through the surplus or the stock dividend, will show itself in the enhanced price received, and he will have to pay a tax on the profit. But at that time he will be cashing in his profit and will be perfectly able to pay the tax out of that particular income instead, perhaps, of being forced to sell capital or borrow money in order to pay a so-called income tax which would not be a tax on income.

A very interesting discussion of this subject from

the economic point of view has been published in Vol. III of the Bulletin of the National Tax Association, April-June, 1918. At page 161 is an article on *"The Economic Nature of the Stock Dividend"* by Prof. Fred. Rogers Fairchild, Professor of Political Economy at Yale University: at page 237, a reply thereto by Henry H. Bond, State Income Tax Deputy, at Boston, Mass., in an article entitled "A Practical Aspect of the Stock Dividend Question"; and on page 240 another article by Prof. Fairchild entitled "The Stock Dividend—a Rejoinder."

Below are some quotations from Prof. Fairchild's articles:

> **"It is unfortunate that the term 'dividend' was ever used in this sense. The 'stock dividend' is really not a dividend at all, but merely a bookkeeping change in the liability of the corporation to its stockholders. Were it not for this unfortunate use of terms, the common notion that a stock dividend is income, like a cash dividend, would probably never have occurred to anyone."**

Again:

> "The inclination to regard a stock dividend as income may sometimes be traced back to the notion that an increase in the value of capital is income. This fundamental error has been the cause of much confusion. Let us see exactly what is the relation between capital and income. Capital is a fund or stock of wealth in existence at a given time. Income is the flow of services or benefits of capital during a period of time. * * * Income must not be confused with growth of the capital."

* * * * * * * *

> **"The Supreme Court, in deciding that a stock dividend is not income, was therefore following sound economic principle."**

> * * * "it is worthy of note that some of the most serious errors in our tax legislation have been due to confusion as to the true nature of capital and income and their relation to each other. The clear-cut decision of the Supreme Court as to the stock dividend was greatly needed."

At page 242:

> **"Whether the dividend is paid in cash, in stocks of other companies, in tons of coal, or anything else, so long as something is taken from the corporation's assets and given to the stockholders, the latter have received income from the corporation. The pro rata distribution of new shares of the corporation's own stock does not do this. * * *"**
>
> "The whole difference between the cash dividend and the other cases (those referred to by Mr. Bond) is that in the first the value of the shareholder's capital represented by the stock has been reduced and income has been received, whereas in the two other cases there has been no such reduction of capital and no income."

Mr. Bond's article at page 237 is scarcely occupied with a real analysis of the subject or the intrinsic merits of the question, but rather with citing examples of well known companies that have declared stock dividends where the shares subsequently rose greatly in value, and deducing from these particular facts the general conclusion that the total market values of the stockholder's holdings invariably rise on the declaration of a stock dividend, and that therefore the stock dividend constitutes income.

**But it is a fallacious argument in support of the taxation of stock dividends that the total value of a stockholder's unsold holdings is often raised thereby in market value.**

**Shares also rise when a company's report shows that it has recently made large surplus earnings. Are these too income to the stockholders even though not distributed?**

Mr. Bond admits that they are not, for he says: "It (*income*) is not received by a stockholder when merely added to corporate surplus." If this be correct, and we submit that it is, this shows that the market value of unsold shares has nothing to do with the case,—any more than a rise in the market value of one's real estate or of a herd of cattle.

And cases are numerous where shares of stock decline in value on the declaration of a stock dividend—so that the aggregate market value may be less than before. Is such a stock dividend nevertheless income also, although it represent a capital loss?

**The truth is that the only bearing of market value is as and when the stockholder elects to sell a part of his stock. Then it is that market value determines whether his stock dividend represents a realized gain and therefore income or a realized loss. To make this fallacy clearer, let us consider the converse of a stock dividend.**

Suppose a company has sustained losses impairing its capital 50 per cent. and that it reduces its capital stock accordingly—stockholders now being compelled to give up 50 per cent. of their old stock. Is this a loss that may be deducted from their other income? Manifestly not, because it is not a realized loss. They continue to retain their same proportionate interests in the company. The company may recoup that loss later. They are at liberty to sell their stock and realize their loss at once and deduct it. But so long as they hold their stock, such a loss is but an inchoate loss, a potential loss, an unrealized loss, an unseparated loss, and one that

in fact ultimately may never turn out to be a real loss at all.

This antithesis between a plus stock dividend and a minus stock dividend makes it clear that corporate gains and corporate losses even though they be represented by an increase or decrease of capital stock and even though they be accompanied by changes in market value are not income gains or income losses of the shareholder.

In sound economics this is so, and in law this is so too, if we are to uphold the rule upon which all our vast system of corporate enterprise is founded —that rule, or legal fiction, which regards the corporation as an entity distinct from its shareholders.

We may freely admit that as a general rule the stock of a well-managed company that pays so-called extra dividends in stock besides its cash dividends will sell at higher prices than a stock which earns the same amount but accumulates the difference as a surplus. If there were no advantage in the declaration of stock dividends, it is reasonable to suppose that these would not be declared. But these advantages, whatever they are, are not income; and as was so well put by Mr. Justice HOLMES in *Towne* v. *Eisner,* "If the plaintiff gained any small advantage by the change, it certainly was not an advantage of $417,450, the sum upon which he was taxed." 245 U. S., at p. 426. (This having been the amount of the so-called stock dividend.)

One of these advantages is that stock dividends afford a convenient way of increasing the cash dividends in a gradual way as the annual earnings may be increased by the earning power of the undivided earnings that are capitalized. A company that each year pays 6 per cent. in cash dividends

and 5 per cent in stock, in reality increases its cash dividends 3/10 of 1 per cent. each year over the year before. It would be difficult to express this regular increase of rate on an unchanged capital stock without having resort to an ever increasing complication of fractions in the dividend rate.

It is surely also an advantage to stockholders to have the fact of the capitalization of earnings officially authenticated by a stock dividend. It does point to the prosperity of their company. Annual stock dividends indicate progressively increasing earning power.

There may be other incidental advantages. The sentiment of having more counters is potent with many persons.

But certainly no one of these advantages nor all of them together constitute income—nor do they make income of that which would not have been income without them.

In any case the advantage of declaring a stock dividend over leaving the same amount in undivided surplus is certainly not equal to the amount of the stock dividend. In fact, these advantages are all speculative or doubtful. In some cases a stock dividend causes a fall in the total market value of the stock holdings. The market's attitude towards stock dividends is always a matter of doubt, and can never be predicted. Sometimes stock dividends are declared where the stock is selling below par, and being badly received by the market, the shares decline still further, although earnings may have fully justified the capitalization of the year's surplus into a stock dividend.

In conservatively managed companies, on the other hand, which pay regular cash dividends and earn a surplus, it cannot be denied that in the long run the payment either regularly or occasion-

ally of stock dividends through a capitalization of earned surplus into shares of stock that are expected themselves to go in the future and pay similar dividends will add considerably to the favor with which such a company is regarded and to the market value of its shares.

In some companies not so conservatively managed such a stock dividend policy would be regarded as unsound finance, and cause a fall in price.

This shows how utterly fallacious it is to regard an increase in market value as income in and of itself, unless it is realized by a sale of stock. It is neither income itself, nor in any slightest degree proof that an unrealized stock dividend is income. If the stocks of well managed companies that pay stock dividends should sell proportionately higher than those of others, in what way does this increase in market value constitute income? Only in one way and that is where the stockholder shall elect to sell. He will then get a higher price, and at that time, the United States Revenue will get a larger income tax because of the fact that the stock-dividend-paying stock will have sold higher proportionately than the stocks of those companies which merely accumulate the same amount in surplus. **The truth is that the United States Revenue will in the long run and over a period of years gain more revenue by a policy of exempting stock dividends than by taxing them.**

But these considerations as raised by Mr. Bond are all incidental and have nothing to do with the main and the intrinsic question which in its two-fold aspect is this:

(1) In sound economics can an undivided surplus of a corporation be regarded as income of the stockholder; and (2) can that same surplus, mere-

ly because capitalized by stock dividends, be deemed income although the stockholder receives nothing intrinsic that he did not have before?

Undoubtedly, these undivided surpluses and these so-called stock dividends do increase the stockholder's capital values. They are gains in a sense, but they are inchoate gains, unrealized gains; they take nothing from the corporation and they only become income when realized through sale. Unlike a dividend in cash or tons of coal, or stocks of other companies, he gets no new thing separated from his company of which he may dispose as he pleases without in any way affecting his interest in his company.

> "While a stock dividend would increase the number of his shares, it proportionately diminishes the value of each of his shares, leaving the aggregate value as it was before."
>
> *Staats* v. *Biograph Co.*, 236 Federal, 454, 457.

Market value then has nothing to do with the case. The whole basis of the claim that a stock dividend is income is that the corporation has made earnings and has capitalized them by this new stock. The basis for the claim is the earnings of the corporation and not the market value of the stock. Now, the earnings of the corporation and the real capital of the corporation are precisely the same whether a stock dividend is declared or whether it is not declared. This fallacy of talking about market values obscures this fundamental fact. The earnings certainly exert an influence on market value. The declaration of a stock dividend may or may not exert an influence on market value but market value has no bearing on the income of the

teenth Amendment cannot now be construed as embracing stock dividends in its use of the word *"Income"* without enlarging it so as to embrace matters not specifically pointed out—without in fact altering the definition of the word laid down by the highest judicial authority and without violating rules of sound economic reasoning as well.

Its use in the sense in which it had been judicially construed should be presumed.

*Latimer* v. *U. S.*, 223 U. S., 501, 504.

> "It is a well settled rule of construction that language used in a statute which has a settled and well-known meaning sanctioned by judicial decision is presumed to be used in that sense by the legislative body."

And see

*Kepner* v. *U. S.*, 195 U. S., 100, 124;
*The Abottsford*, 98 U. S., 440.

## SECOND POINT.

**Although the *Hubbard* case is plainly distinguishable from the case at bar, it is nevertheless inconsistent both with other and later rulings of this Court and with sound economics. It tends to block the way to a consistent, harmonious and logical system of income taxation and it should be expressly overruled.**

The case was decided upwards of fifty years ago, when the income tax had been but little studied either in its economic or in its constitutional aspects.

It turned principally on questions of procedure. The grave constitutional questions involved which were subsequently to demand the most earnest consideration of this Court in the *Pollock* case were scarcely referred to. The *Pollock* case, the Sixteenth Constitutional Amendment and subsequent cases, have since then settled the underlying principles involved.

As the Attorney General substantially rests his case on *Collector* v. *Hubbard,* it will be worth while to analyze this case with some particularity, so as to show how inapplicable it is to present conceptions of taxation—whether economic or constitutional.

*Collector* v. *Hubbard* (12 Wall., 1) arose under the income tax provisions of Chapter 173, Laws of 1864.

As applied to corporations the scheme of the Act was to provide a 5 per cent. tax on all corporate earnings.

Section 122 provided for a 5 per cent. tax on the amount of interest, dividends or profits of railroad, canal and turnpike companies.

Section 120, a similar tax upon the earnings of banks, trust companies and insurance companies.

Section 117 put all other companies, including manufacturing companies, in a class by themselves and sought to accomplish the same result by the indirect method of taxing the stockholders instead of the corporation. That section provided that the gains and profits of a corporation should be included in estimating the annual gains, profits and income of any person entitled to the same, whether divided or otherwise. In other words, each stockholder in these last named companies, for reasons that do not appear, was required to report as part

of his income his *pro rata* of the earnings, divided or undivided, of any corporation in which he held stock and to pay the 5 per cent. tax thereon, while the corporations themselves of this class were not taxed at all.

Whatever may be thought of making stockholders pay taxes on undivided corporate profits never received and perhaps never to be received by them —the object of the Act at least was to levy a uniform tax on the earnings of all corporations alike for each taxable year. Only the method of assessing or levying the tax varied with the two classes of corporations. This was recognized by the then Attorney General in his argument of that case, wherein he said: "In all cases the entire annual gains and profits of every corporation, divided or undivided, seem to be within the aim and province of the statute as objects of taxation."

This was no case of double taxation. Only one tax was to be levied on any one year's corporate earnings, but that was levied not on the corporation but on its shareholders.

Nor was it a case of taxing the earnings for a year subsequent to the year when earned and at a time when they had really become capital. Least of all was it a case of first exacting an income tax from the corporation in one year and then treating those same earnings though undivided as the income of the stockholder in the next succeeding year.

The corporate earnings of manufacturing companies as such were deemed by the Statute, whether rightly or wrongly, to be the taxable interest of the stockholders but only for the year when earned by the Company.

Whilst it is believed and will be argued later on that any such enactment as Section 117 would now

be unconstitutional—it is important to stress these facts because they establish essential differences between the *Hubbard* case and the contentions of the Government here.

Another important fact is that the constitutionality of making stockholders pay an income tax on income never received by them seems to have received little or no consideration in that case.

Only in the last few short paragraphs of the Court's opinion were the merits considered—that is, the right of Congress to levy such a tax on corporate earnings against the stockholder and after scant consideration it seems to have been thought that the stockholder's interest in the earnings was taxable as a property interest.

**(a) The Hubbard case as upholding a tax on property or on the income from property except by apportionment under Article I, §2 of the Constitution has been overruled by the Pollock case.**

This the Attorney General virtually admits, but he argues that the tax would have been invalid under the *Pollock* decision, not because the views announced in the *Hubbard* case were unsound, but because the Hubbard tax was a direct tax on property and not apportioned among the states, and he argues in effect that the Sixteenth Amendment, which does not authorize a direct tax at all, but merely relieves from the rule of apportionment taxes on the income of property from whatever source derived, would again today reauthorize a tax like that in the *Hubbard* case.

But the tax involved in the *Hubbard* case actually was a direct tax on property and would be so considered at this day. The Sixteenth Amendment has no application to such a tax. The very

views expressed by the Court and which the Government quotes in its support show that it considered the stockholder's interest in the corporation and its earnings as a property interest. This is what the Court said:

> "* * * undivided profits are the property of the shareholder * * *"
>
> "undivided profits invested in real estate, etc. * * * are investments in which the shareholders are interested."
>
> "Annual gains and profits, whether divided or not, are property and therefore are taxable."

If the shareholder has any interest in these corporate gains and profits before they are divided as dividends, it is a property interest and a tax upon it against the shareholder would be a direct tax now as much as ever. The Sixteenth Amendment does not touch it. For these corporate profits are not income of the shareholder. They are as the Court says, property. As such they may be taxed but the tax being a direct tax would now, since the *Pollock* case, have to be apportioned.

These remarks of the Court that these undivided corporate gains are property of the shareholder may not be easily reconciled with what it elsewhere says to the effect that "it is as competent for Congress to tax annual gains and profits before they are divided among the holders of the stock as afterwards."

If it be meant by that, that Congress has power to tax total corporate gains and profits against the corporation, there can be no doubt of it. But if it be meant thereby that Congress may levy against the stockholder a tax on the undivided gains and profits of the corporation, then with due respect, the statement is not sound law. The stockholder's

interest in these undivided gains is property, as the Court so well said; it is included in his ownership of stock in the corporation and a tax on them would be in effect a tax on his stock, a direct tax and not an income tax.

This confusion of language, if we may be permitted to call it such, is all due to the views generally entertained at the time of the *Hubbard* case which arose in consequence of the *Hylton* case (*Hylton* v. *U. S.*, 3 Dallas, 171) that a tax on carriages or other personal property was an excise tax and not a property tax or a direct tax. Taxes on personal property and on incomes, both having been at that time regarded as excise taxes, there was no occasion for the Court to distinguish between them. Therefore, whether the tax of 1864 were deemed a personal property tax or a tax on profits or on income, it seemed equally to be an excise tax and within the power of Congress. In neither case did an apportionment then seem necessary.

But the *Pollock* case holds that a tax whether on property or on the income from property is a direct tax.

The Sixteenth Amendment merely authorizes a tax on the income from property without regard to apportionment and leaves direct taxes on property, real or personal, where the *Pollock* case left them.

> *Brushaber* v. *Union Pacific R. R. Co.*, 240 U. S., 1.

So that the *Pollock* case, notwithstanding the Sixteenth Amendment, remains today as a barrier against the taxation of a stockholder's interest in the corporation or its undivided profits—for these are as to him property and such a tax would be a direct tax.

How can the stockholder's interest in the undivided earnings of his corporation be anything else than property? They are a gain if one please. They constitute an addition to the value of his capital. But for all the control he has over them they are no more of a gain than an appreciation in the value of his real estate. In neither case can he enjoy the gain unless he sell.

In *Southern Pacific Co.* v. *Lowe*, 247 U. S., 330, 335, this Court said, speaking of the accumulations of earnings in that case:

> "* * * we are bound to consider the accumulations that accrue to a corporation prior to January 1, 1913, as being capital and not income. *And we perceive no adequate ground for a distinction in this regard between an accumulation of surplus earnings and the increment* due to an appreciation in the value of the assets of the taxpayer."

And there surely is no distinction as regards the taxpayer at any given date, whether his capital values have increased through mere appreciation in market values as of real estate, or whether his stock has been made more valuable intrinsically by earnings that he is not allowed to receive and enjoy. Neither sort of gain constitutes income to him. This has been abundantly shown in the preceding discussion of economic doctrine. But the man in the street knows this for himself without argument. He knows that where a corporation fails to pay him dividends out of its earnings he has no income. An appreciation of capital he may have. This may even be ultimately more valuable to him than the cash dividend. But income it is not. It cannot pay butcher's or grocer's bills or taxes. And income which cannot be made to do these things is

not intrinsically income, and it seems preposterous to suppose that the Sixteenth Amendment could refer to income in any such sense. These unrealized gains are property, are capital, and nothing else.

It may be proper to tax these accretions—appreciation in value of real estate or securities, undivided surplus of corporation. But if so, they should be taxed for what they are—property interests—and the taxes would have to be apportioned. Before they can properly be taxable as income either in the economic or in the popular sense or as we believe in the constitutional sense, they must be made income by a sale of the property so that the gains may have been realized.

The title both legal and equitable in corporate property and in corporate earnings is in the corporation. This the Court admitted in the *Hubbard* case. If the title is in the corporation, then it certainly is not in the stockholder, and it is difficult to see how he can have any taxable interest either in the corporate property or its earnings. The Court there avoided this difficulty by remarking that the stockholder is an owner of shares and that one of the incidents of shares is "the right to receive all future dividends." But the right to receive future dividends, which may never be declared, is certainly not the same thing as the receipt of real dividends actually declared—and such a right certainly does not constitute income. It is an inherent right of property in the shares and it is a property attribute but it is a contingent right at best.

The notion that such an abstraction as a contingent right to receive future dividends if and when other wills than ours choose to declare them constitutes a present taxable income for us, shows how thoroughly the Court was governed in the *Hubbard*

case by the authority of the *Hylton* case, that a tax on carriages and personal property generally was an excise tax and similar in that regard to the income tax—a view definitely overruled by the *Pollock* case, and which to that extent must be deemed to have been confirmed by the Sixteenth Amendment.

But *Gibbons* v. *Mahon*, 136 U. S., 549, is decisive of this question, that a stockholder's interest in corporate earnings is property, is capital.

> **"Reserved and accumulated earnings, so long as they are held and invested by the corporation, being part of its corporate property, it follows that the interest therein represented by each share is capital and not income of that share, etc., etc." (p. 558).**

So that in whatever way one looks at the *Hubbard* case, and whatever way may have been the judicial view in 1864, the subject matter there taxed was not income but property and being property the case and the grounds upon which it rested have been overruled by *Pollock* v. *Farmers' Loan & Trust Co.*, 157 U. S., 429.

**(b) THE HUBBARD CASE, INSOFAR AS IT ASSUMES AN EQUIVALENCY BETWEEN THE PROPERTY AND THE INCOME OF THE CORPORATION AND THE SHARES OF STOCK IN THE NAMES OF THE STOCKHOLDERS FOR TAXATION PURPOSES, HAS BEEN IMPLICITLY OVERRULED BY A LONG SERIES OF AUTHORITIES IN THIS COURT.**

The novel principles imagined in Chapter 173, Laws of 1864, for imposing the income tax of a corporation upon its stockholders and the views expressed thereon in Collector v. Hubbard as interpreted by the Attorney General here, would completely obliterate the well-established legal entity of the corporation as distinct from its stockholders and make of it for taxation purposes a partnership.

They do more, because in a partnership, partners required to pay a debt of the partnership would have recourse to the corporate fund to recoup themselves. But stockholders paying a tax under the Act of 1864 on the undivided earnings of their corporations would have no such right to compel repayment by the corporation.

**The corporate entity cannot be disregarded as is urged by the Government in this case, or as the language used by Mr. Justice Clifford in the Hubbard case would seem to warrant.**

> "The corporation is a person distinct from the stockholder. It is true, it is what is denominated an artificial person, and may be said to be ideal and intangible. But that it is a person in law is the first principle learned by the student in opening any book on corporations. Its stockholders are distinct and different persons. They are usually not liable for its debts, and have no right to the *enjoyment or possession* of its property during the period of its duration or until it be dissolved by some procedure known to the law." (Italics ours.)
>
> *Cook* v. *Burlington*, 59 Iowa, 251.

In an early decision of this Court, in which the opinion was written by no less a personage than Chief Justice MARSHALL, the Court permitted itself to ignore the separate legal entity of a corporation, and to treat it as a mere aggregation of its members. But subsequent consideration satisfied the Court of its error, and even the illustrious Chief Justice acknowledged the mistake made in departing from the settled principles of corporation law. The history is interesting and instructive. The case was that of *Bank of United States* v. *Deveaux*, 5 Cranch, 84. The question there was, whether or not a corporation might sue in the Federal Courts

under the Judiciary Act, which extended the judicial power of the United States to controversies between citizens of different States. Was a corporation a citizen of the State of its incorporation within the meaning of this act, irrespective of the citizenship of its members? The Court decided it was not. Chief Justice MARSHALL, writing the opinion of the Court (following a previous ruling in *Strawbridge* v. *Curtis*, 3 Cranch, 267), held that

> "That invisible, intangible, and artificial being, that mere legal entity, a corporation aggregate, is certainly not a citizen; and, consequently, may not sue or be sued in the courts of the United States, unless the rights of the members, in this respect, can be exercised in their corporate name. If the corporation be considered as a mere faculty, not as a company of individuals, who in transacting their joint concerns, may use a legal name, they must be excluded from the courts of the union."

Therefore, it was held that the Court might look to the character of the individuals who composed the corporation, and if all of them were citizens of a state other than that of the opposite party to the suit, maintain the jurisdiction of the Federal Court, but not otherwise. This decision is about the only recorded example of a narrow construction by Chief Justice MARSHALL of the powers granted by the Constitution to the federal government.

In *Louisville R. R. Co.* v. *Letson* (2 How., 497), the question again was presented to the Court. Referring to the previous decisions of *Bank of United States* v. *Deveaux* (5 Cr., 84) and *Strawbridge* v. *Curtis* (3 Cr., 267), Mr. Justice WAYNE delivering the unanimous opinion of the Court said:

> "We do not deny that the language of those decisions do not justify in some degree the in-

ferences which have been made from them, or that the effect of them has been to limit the jurisdiction of the circuit courts in practice to the cases contended for by the counsel for the plaintiff-in-error. The case of *Strawbridge* and *Curtis* was decided without argument. That of the *Bank* and *Deveaux* after argument of great ability. But never since that case has the question been presented to this Court, with the really distinguished ability of the arguments of the counsel in this, in no way surpassed by those in the former. And now we are called upon in the most imposing way to give our best judgments to the subject, yielding to decided cases everything that can be claimed for them on the score of authority, except the surrender of conscience. After mature deliberation, we feel free to say, that the cases of *Strawbridge* and *Curtis,* and that of the *Bank* and *Deveaux,* were carried too far, and that consequences and inferences have been argumentatively drawn from the reasoning employed in the latter which ought not to be followed. Indeed, it is difficult not to feel that the case of *The Bank of the United States* and *The Planters' Bank of Georgia,* 9 W., 904, is founded upon principles irreconcilable with some of those on which the cases already adverted to were founded. The case of *The Commercial Bank of Vicksburg and Slocomb,* 14 P., 60, was most reluctantly decided upon the mere authority of those cases. We do not think either of them maintainable upon the true principles of interpretation of the constitution and laws of the United States. A corporation, created by a State, to perform its functions under the authority of that State, and only suable there, though it may have members out of the State, seems to us to be a person, though an artificial one, inhabiting and belonging to that State, and therefore entitled, for the purpose of suing and being sued, to be deemed a citizen of that State. We remark,

too, that the cases of *Strawbridge* and *Curtis*, and the *Bank* and *Deveaux*, have never been satisfactory to the bar, and that they were not, especially the last, entirely satisfactory to the court that made them. They have been followed always most reluctantly and with dissatisfaction. By no one was the correctness of them more questioned than by the late Chief Justice who gave them. It is within the knowledge of several of us, that he repeatedly expressed regret that those decisions had been made, adding, whenever the subject was mentioned, that if the point of jurisdiction was an original one, the conclusion would be different. We think we may safely assert, that a majority of the members of this court have at all times partaken of the same regret, and that, whenever a case has occurred on the circuit, involving the application of the case of the *Bank* and *Deveaux*, it was yielded to, because the decision had been made, and not because it was thought to be right. We have already said that the case of *The Bank of Vicksburgh* and *Slocomb*, 14 Pet., 60, was most reluctantly given, upon mere authority. We are now called upon, upon the authority of those cases alone, to go further in this case than has yet been done. It has led to a review of the principles of all the cases. We cannot follow further, and upon our maturest deliberation we do not think that the cases relied upon for a doctrine contrary to that which this court will here announce, are sustained by a sound and comprehensive course of professional reasoning. Fortunately, a departure from them involves no change in a rule of property."

This decision was followed in *Marshall* v. *B. & O. R. R. Co.*, 16 How., 314, and *Covington D. Co.* v. *Shepherd*, 20 How., 227, and the rule there adopted that a corporation is a legal entity—a person—created by the state of its incorporation, entirely

distinct from the individuals who compose its membership, was definitely and finally declared to be the law by Chief Justice TANEY in *O. & M. R. R. Co.* v. *Wheeler,* 1 Black, 286.

In *Humphreys* v. *McKissick,* 140 U. S., 304, 312, Mr. Justice FIELD said:

> "The property of a corporation is not subject to the control of individual members, whether acting separately or jointly. They can neither encumber nor transfer that property, nor authorize others to do so. The corporation—the artificial being created—holds the property, and alone can mortgage or transfer it, and the corporation acts only through its officers, subject to the conditions prescribed by law."

In *Donnell* v. *Herring-Hall-Marvin Safe Co.,* 208 U. S., 267, 273, Mr. Justice HOLMES said:

> "Philosophy may have gained by the attempts in recent years to look through the fiction to the fact and to generalize corporations, partnerships and other groups into a single conception. But to generalize is to omit, and in this instance to omit one characteristic of the complete corporation, as called into being under modern statutes, that is most important in business and law. A leading purpose of such statutes and of those who act under them is to interpose a non-conductor, through which in matters of contract it is impossible to see the men behind."

In *Southern Pacific Co.* v. *Lowe,* 247 U. S., 330 (1918), the corporate fiction was disregarded but the case is valuable for PITNEY, J.'s, caution (page 338) that:

> "The case turns upon its very peculiar facts and is distinguishable from others in which the question of the identity of a controlling stockholder with his corporation has been raised."

In this case, the Southern Pacific Co. owned all the stock in the Central Pacific Railroad; the latter railroad had earned certain surplus profits and these the Southern Pacific Co., as sole stockholder, caused to be converted into a cash dividend, and paid to itself. The surplus profits accrued before March, 1913; the dividend was declared and paid after March, 1913. The transaction was held not taxable.

In *Pullman Car Co.* v. *Missouri Pacific Railway Co.,* 115 U. S., 587 (1885), it was held that an agreement by the respondent railroad to haul Pullman cars over roads controlled by lease or ownership did not import an obligation to haul cars over roads owned by companies in which the respondent held practically all the stock. In *Peterson* v. *Chicago, Rock Island & Pacific Railroad,* 205 U. S., 364, 391 (1907), it was held that a railroad was not shown to be doing business in a certain State if it was merely shown to have been the owner of practically the entire capital stock of another railroad which operated in that particular State. See also *Stone* v. *Cleveland C. C. & St. L. Railroad,* 202 N. Y., 452 (1911).

The same principle was involved in *Continental Tyre Co.* v. *Daimler* (1915), 1 K. B., 893 (reversed by the House of Lords on a question of termination of agency by war (1916) 2 A. C. 307). The issue there was the permissibility of payments in wartime to a corporation chartered under the English Companies Act, the majority of whose stockholders were subjects of Germany. The court rejected the plea of the debtor that the substance and not the technicalities of the matter should be regarded, saying:

> "It cannot be technically an English company and substantially a German company ex-

cept by the use of inaccurate and misleading language. Once it is validly constituted as an English company it is an artificial creation of the Legislature and it retains its existence for all intents and purposes. It is a living thing with a separate existence which cannot be swept aside as a technicality. It is not a mere name or mask or cloak or device to conceal the identity of persons and it is not suggested that the company was formed for any dishonest or fraudulent purpose. It is a legal body clothed with the form prescribed by the Legislature."

A like decision was rendered by the New York Supreme Court in a similar case. See *Schulz* v. *Raimes,* 100 Misc. (N. Y.), 697 (1917).

This principle especially should be adhered to on a question of taxation.

Taxes are, fundamentally, the price paid by property owners for the assurance to them by the State that they will be protected in the enjoyment of their property. *Union Refrigerator Transit Co.* v. *Kentucky,* 199 U. S., 194, 204 (1905). They should therefore not be assessed upon property which they have no right to enjoy.

**The exceptional cases where the corporate entity has been disregarded but serve to prove the rule.**

These cases generally are those where not to disregard the fiction, would permit the corporation or its stockholders to evade contractual obligations or commit a fraud or a crime with impunity, or, as in *Southern Pacific Co.* v. *Lowe, supra,* would permit the imposition of unjust burdens upon the corporation.

In *United States* v. *American Refrigerator Transit Co.,* 142 Fed., 247 (1905), the United States sought to restrain the paying of rebates to a shipper in violation of the Elkins Act. The defense was that

the defendant was not a shipper but a freight soliciting agent. All the stock in the defendant was owned by the Pabst Brewing Co., and members of the Pabst family, and the Brewing Company made all its shipments through the defendant's agency. It was held that the corporate fiction would be disregarded and an injunction issue.

(*United States* v. *Lehigh Valley Railroad,* 200 U. S., 257 (1911); *United States* v. *Delaware, L. W. Railroad,* 238 U. S., 516, 529 (1915); *Brundred* v. *Rice,* 49 Oh. St., 540, involve a similar principle.)

In *Linn Timber Co.* v. *United States,* 236 U. S., 574 (1915), it was held that one who had notice of a defect in his title could not create a corporation and, becoming its chief stockholder, sell his land to the corporation as to a *bona fide* purchaser, with a view toward cutting off the claims which had made his title defective.

In *People* v. *North River Sugar Refining Co.,* 121 N. Y., 582 (1890), several corporations engaged in the business of refining sugar, including the defendant corporation, made through their directors an agreement whereby all the stock of all the corporations was transferred to certain trustees. The defendant then ceased to refine sugar. Upon the bringing of a writ of *quo warranto* to wind up the corporation, the contention was made that the corporation had committed no offense, and that only the stockholders and directors were guilty. The court refused to recognize the corporate fiction and, holding that there had been corporate action, refused to allow the writ to be defeated by "the assumed innocence of a convenient fiction" (p. 622).

In *First National Bank* v. *Trebein,* 59 Oh. St., 316, 52 N. E., 834 (1898), the debtor Trebein formed a corporation with his wife, daughter, son-in-law

and brother-in-law, and conveyed all his property to it. The court ordered the conveyance set aside, but denied that the property could have been sold on execution by Trebein's own creditors prior to reconveyance. The language of the court, however, on the circumstances under which the fiction may be disregarded goes beyond the rule sustained by authority.

> "But modern cases, sustained by the best text writers, confine the fiction to the purposes for which it was adopted—convenience in the transaction of business and in suing and being sued in its corporate name, and the continuance of its rights and liabilities, unaffected by changes in its corporate members; and have repudiated it in all cases where it has been insisted on as a protection to fraud or any other illegal transaction."

A better statement of the law is that of HAIGHT, D. J., in *Peckett* v. *Wood*, 234 Fed., 833, 838 (1916), quoted *infra*, p. 49.

There seems to be perfect unanimity among the authorities in cases where a person, having contracted not to engage in a certain business, proceeds to form a corporation with himself as chief stockholder and to carry on the prohibited business under the corporate name. It is proper in such cases to enforce the contract by injunction directed against the corporation: *Moore & Handley Co.* v. *Towers Hardware Co.*, 87 Ala., 206 (1880); *Beal* v. *Chase*, 31 Mich., 490; *Hall's Safe Co.* v. *Herring-Hall-Marvin Safe Co.*, 146 Fed., 37 (1906). But a strong case for preserving intact the corporate fiction though it be employed to evade a detrimental contract is *People's Pleasure Co.* v. *Rohleder*, 109 Va., 439, where a covenant not to convey to persons

of African descent was held not violated by conveyance to a corporation composed exclusively of colored persons.

The case of *In re Rieger,* 157 Fed., 609, along with *In re Muncie Pulp Co.,* 139 Fed., 546 and *Hunter* v. *Baker Motor Vehicles Co.,* 225 Fed., 1006, aff'd. 238 Fed., 894, are instances of the "mere adjunct" cases where the corporate fiction is regarded with impatience. In those cases it was disregarded, not because to do so is the only way to prevent fraud, but simply to avoid circuity of action and expenditures of time—"in a case where a corporation is so organized and controlled and its affairs are so conducted as to make it merely an instrumentality or adjunct of another corporation." Per NOYES, C. J., *In re Watertown Paper Co.,* 169 Fed., 252, 256 (1909). These "mere adjunct" cases are unsound in that they turn on what is at best a question of degree; and they furnish no unequivocal criterion of responsibility. They have not been approved by this Court.

Judge NOYES, in his opinion, reaffirmed the general rule in this language:

> "Now, it is an elementary and fundamental principle of corporation law that a corporation is an entity separate and distinct from its stockholders and from other corporations with which it may be connected. The fact that the stockholders of two separately chartered corporations are identical, that one owns shares in another, and that they have mutual dealings, will not, as a general rule, merge them into one corporation, or prevent the enforcement against the insolvent estate of the one of an otherwise valid claim of the other * * *. Unless, therefore, it can be shown that some exception to the general rule of separate existence and liability applies in this case, it must follow that the

claim of the Pulp Company should have been allowed."

HAIGHT, D. J., in *Peckett* v. *Wood,* 234 Fed., 883, 838 (1916), in an opinion upon which the C. C. A. (3rd Circ.) affirmed the judgment, insists very strongly upon the recognition of the corporate entity except for the prevention of fraud, or some like consideration.

> "Although, as was said in the *Watertown Paper Company* case, *supra,* in some cases, when necessary for the furtherance of justice in one way or another, corporate entity may be disregarded where the corporation is so organized and controlled and its affairs are so conducted as to make it merely an instrumentality or adjunct of another concern, yet this is an exception to the general rule and fundamental principle that a corporation is an entity, separate and distinct from its stockholders, and from other concerns with which it may be connected * * *. Except in cases where it is necessary to circumvent fraud, or in cases which proceed on the theory of estoppel, or those where it is sought to take possession of property ostensibly belonging to a corporation entirely controlled and owned by the principal debtor, for the purpose of protecting the creditors of the latter, as well as the former, it will be found that the instances are rare indeed where the general and settled rule of separate corporate identity is disregarded."

The provisions of Section 3 of the Income Tax Law of 1916, fall within the exceptions to the general rule. The section provides that:

> "For the purpose of the additional tax, the taxable income of any individual shall include the share to which he would be entitled of the gains and profits, if divided or distributed,

> whether divided or distributed or not, of all corporations, joint stock companies or associations, or insurance companies, however created or organized, formed or fraudulently availed of for the purpose of preventing the imposition of such tax through the medium of permitting such gains and profits to accumulate instead of being divided or distributed; and the fact that any such company * * * is a mere holding company, or that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be *prima facie* evidence of a fraudulent purpose to escape such tax * * *."

That a fraud upon the law may not be accomplished by resorting to an otherwise legal form of organization is well settled. The anti-trust cases are illustrations of this principle—

> *Northern Securities Co.* v. *U. S.*, 193 U. S., 197;
> *Standard Oil Co.* v. *U. S.*, 221 U. S., 1;
> *U. S.* v. *American Tobacco Co.*, 221 U. S., 106.

The separateness of the corporation and its shareholders has never been more emphatically expressed than in recent opinions of this Court. In *Gibbons* v. *Mahon*, 136 U. S., 549, it was said:

> **"The distinction between the title of a corporation and the interest of its members or stockholders in the property of the corporation is familiar and well settled.** The ownership of that property is in the corporation, and not in the holders of shares of its stock. The interest of each stockholder consists in the right to a proportionate part of the profits whenever dividends are declared by the corporation during its existence under its charter, and to a

like proportion of the property remaining, upon the termination or dissolution of the corporation, after payment of its debts.

**"Money earned by a corporation remains the property of the corporation and does not become the property of the stockholders unless and until it is distributed among them by the corporation.** The corporation may treat it and deal with it either as profits of its business, or as an addition to its capital."

In *Lynch* v. *Hornby*, 247 U. S., 339, this Court said:

"The stockholder is in the ordinary case a different entity from the corporation * * *"

In *Peabody* v. *Eisner*, 247 U. S., 347, it was said:

"In this case the plaintiff-in-error stands in the position of the ordinary stockholder, whose interests in the accumulated earnings and surplus of the company are not the same before as after the declaration of a dividend; his right being merely to have the assets devoted to the proper business of the corporation and to receive from the current earnings or accumulated surplus such dividends as the directors, in their discretion, may declare; and without right or power on his part to control that discretion."

See also a long line of cases on the taxation of bank stock, etc., cited in the main brief of defendant-in-error, wherein it is held that the shares of stockholders may be taxed although the capital of the bank be exempt, the reason being that the capital with its surplus owned by the corporation and the shares owned by the stockholders are different and distinct. Both the nature of the things owned and the ownerships are different.

These principles of law are elementary.

In the case of *Owensboro National Bank* v. *Owensboro*, 173 U. S., 664, Mr. Justice WHITE, referring to these authorities, said:

> "If the postulate upon which they necessarily rest be overthrown by saying that there is an equivalency between the taxation of the property of the Bank and the shares of stock in the names of the stockholders, it would follow that the principles upheld by the cases would disappear with the destruction of the reasons upon which they were placed."

It is because there is no such equivalency that shares may still be taxed where corporate property is exempt by law. Since this equivalency of ownership and this equivalency for taxation purposes is denied as between the shares on the one hand and the corporate property on the other, it follows that the corporate property and the earnings of the corporation cannot be imputed to the holder of the shares for taxation purposes, for this would be to admit the equivalency of the two titles for taxation purposes, which this long series of cases has denied; and *Gibbons* v. *Mahon*, *supra*, overrules the *Hubbard* case, where it says that "money earned by a corporation that is, its income, remains the property of the corporation and does not become the property of the stockholders unless and until it is distributed among them by the corporation."

These cases and the citations that follow are utterly inconsistent with the doctrine of regarding corporate earnings as the income of shareholders. They implicitly overrule the *Hubbard* case and that case should be explicitly overruled.

The net result of the decisions is accurately and

tersely summed up in Vol. 10, Cyclopedia of Law and Procedure, as follows:

"Capital and shares are species of property distinct from one another. The capital or capital stock belongs to the corporation considered as a legal person or entity; the shares are the property of the individual shareholders."

"Shares of stock are personal property."

"Shareholders are not tenants in common or co-owners of the property of the corporation in any sense; but the title thereto rests in the legal entity called the corporation."

"It follows that a shareholder's interest in the property of the corporation cannot be seized and sold under judicial process as can the interest of a partner or tenant in common, although his shares, considered as distinct property, can be."

"The relation of trustee and 'C. Q. T.' of debtor and creditor, or of partners, does not exist between the shareholders of an incorporated company and the corporation itself." They may deal with one another as strangers.

"As already stated, a joint-stock corporation is in general a trustee for its shareholders only so far as may be necessary for the protection of their several rights of property in their several shares."

"Non-liability at Common Law. 1. General Rule. As already seen, a corporation and its shareholders are distinct persons in law. The general rule of law, therefore, is that the shareholders of the joint-stock corporation are not liable for its debts or for its torts, except to make good the amount due to the corporation for their shares, unless made so by constitutional or statutory enactment, or unless they have assumed a larger liability by contract or by conduct."

See pp. 364, 366, 373, 374, 376, 649.)

Not being liable for the corporation's debts, why should they be liable for its taxes?

Elementary as these principles are, it is worth while to recall them in order to show how they contradict the theory that for taxation purposes the undivided earnings of a corporation are the earnings of its stockholders.

There is no element of wrong-doing here—no attempt to evade the payment of a just tax. The contention is that any corporation as a separate legal entity having earned profits should pay the income tax on them. There is no difficulty in compelling it to do so. It is admitted that to the extent that these profits may be actually distributed in dividends the stockholders should pay another tax as on income received by them. It is contended that to make stockholders pay an income tax on the undistributed earnings of a corporation not received by them (as was done in Section 117, Chapter 73, Laws 1864) would not only be a monstrous injustice in itself, but would withdraw that protection against personal liability which the stockholder depends upon in embarking his money and which is one of the principal reasons for the legal fiction of separate corporate entity and separate ownership of property.

So far from this being a case for an exception to the rule of corporate entity, it is a case involving one of the fundamental reasons for its assertion.

Now this rule and the principle of stockholders' exemption from liability are laid down as rules of law by the various states under whose laws most corporations are incorporated. Can it be possible that the Congress has been clothed with the constitutional power to set aside these rules of property for the purpose of levying an income tax not against the corporation which has earned and still holds

the income but against stockholders who do not hold it and may never receive it?

If so, then it would not be difficult to imagine an income tax of 65 per cent. or so levied against some large stockholder upon so-called income of his still held by the corporation—the payment of which could work his ruin.

And a new tax act in such case might levy a similar confiscatory tax on all stockholders alike—big and little. This would be worse than confiscation—for confiscation takes only what one has. This sort of an 1864 tax on undivided corporate earnings would compel stockholders to get money elsewhere by loan or otherwise to pay on income they had never received and perhaps never would receive.

These are but a few of the inequalities and injustices and difficulties that will be met if that principle of Chapter 173, Laws of 1864, is sustained, which permits the taxing power to tax income not where it is but where it is not—to tax the stockholder on earnings of the corporation not received by him.

If Congress may tax these undivided earnings against the stockholder when he has not received them, may it tax them again if and when he receives them as a cash dividend?

And if he pay a tax on them whilst controlled by the company, must he pay again on the profit that his stock may realize when he comes to sell it—a profit made possible by these very accumulated earnings?

Nothing can save us from these inconsistencies but an adherence to the well-established rule and beneficent fiction of the law—that the corporation is a distinct person and entity.

**(c) The suggestion that this Court has in other cases cited Collector v. Hubbard or its principle with approval except upon altogether minor points is erroneous.**

The case of *Bailey* v. *Railroad Company,* 22 Wallace, 604, relied upon by the Government as maintaining the same principles and justifying the taxation of stock dividends has no application here. The case involved a revenue act which taxed not the stockholders but the Railroad Corporation upon all dividends in scrip or money, declared by the Railroad Company as part of the earnings, profit, income or gains of the Company, etc. The earnings of the Railroad Company were manifestly a proper subject for income tax or excise tax. The payment of these earnings in cash dividends among the stockholders or the issuance of scrip was regarded as a fit subject of taxation against the corporation and probably would be so today; but no such question is involved here. No stock dividend was directly involved. It was remarked by this Court subsequently in *Gibbons* v. *Mahon,* that the opinion in the *Bailey* case of Mr. Justice CLIFFORD, the same judge who wrote the opinion in the *Hubbard* case, contained "some general expressions which taken by themselves might seem to ignore the settled distinction between the property of a corporation and the interests of the shareholders." But these remarks of the learned Justice were *obiter* and did not affect the decision of the case, and the learned Justice in making them was undoubtedly governed by the idea prevailing at that time that as a result of the *Hylton* case personal property and its use as well as earnings were a fit subject for an excise tax. If, however, there be anything in the *Bailey* case which seems to lend support to the *Hubbard*

case, whether directly or *obiter,* it must be deemed to have been overruled with the latter case.

In *Lynch* v. *Turrish,* 247 U. S., 221, the question was whether when a corporation was liquidated *in toto* in 1914 the profits that had accumulated on the shares prior to March 1, 1913, could be deemed income or capital. The Court decided that the income had become capital. In reference to *Collector* v. *Hubbard,* it did say that it had been there held that the stockholder could have an interest taxable under the act considered (that of 1864) but it hastened to point out that his interest was *"not identical with the corporation"* and it gave no consideration whatsoever to the question whether such stockholder's interest could be considered income or capital and whether if taxed at this time it could be taxed as income without apportionment or as property with apportionment.

But the most significant fact in answer to the Government's reliance on *Collector* v. *Hubbard* is that in *Southern Pacific Co.* v. *Lowe,* 247 U. S., 330, this Court having an opportunity to rest its decision on *Collector* v. *Hubbard* declined to do so.

In that case the Southern Pacific Company owned all the capital stock of the Central Pacific R. R. Co., and was in possession of all its property and earnings under lease and it treated the whole as its own. Accumulations of earnings had been taken over by it and constituted technically a debt from the lessee. But as the lessee owned all the lessor's stock a formal dividend at any time would have *pro tanto* wiped out the debt. This dividend was not declared formally until 1914, and the Treasury Department claimed that this was taxable as for that year, although the earnings had been received before March 1, 1913, and although this declaration

of dividend was nothing more than a formal ratification by the directors of what was already a *"fait accompli."*

This Court held this dividend not taxable for certain reasons set forth in its opinion. But it expressly disclaimed the idea that it was influenced by *Collector* v. *Hubbard,* and the Court said:

> "We do not rest this (decision) upon the view that for the purposes of the Act of 1913 stockholders in the ordinary case have the same interest in the accumulated earnings of the company before as after the declaration of dividends. The Act is quite different in this respect from the Income Tax of June 30, 1864, under which this Court held in *Collector* v. *Hubbard* * * * that an individual was taxable upon his proportion of the earnings of the corporation, although not declared in dividends."

The Court went on to distinguish that case from the one then at bar.

Only a term or two before *Lynch* v. *Turrish,* this Court had occasion to decide *Towne* v. *Eisner* and it there based itself on *Gibbons* v. *Mahon,* 136 U. S., 549, in which case the distinction between corporate ownership and the interest of shareholders was clearly set forth in this language:

> "The ownership of the property is in the corporation and not in the holders of shares of its stock * * *. Money earned by a corporation remains the property of the corporation and does not become the property of the stockholder unless and until it is distributed among them by the corporation."

In confirmation of this same idea, this Court in *Towne* v. *Eisner* in effect said that if the sum in

question had been carried from surplus to capital account without any stock issue "we do not suppose that anyone would contend that the plaintiff received an accession to his income"; but this is exactly what the Government pretends took place in *Collector* v. *Hubbard*.

As we read these words of the Court, they are in direct contradiction of the Government's view of the *Hubbard* case, and of the *dictum* of the Court in the case itself.

**As we read them, those words quoted from Towne v. Eisner say plainly that undivided earnings passed by a corporation from surplus to capital account would not constitute income of a stockholder, and so we come back to the query—are they made income by the mere fact that their capitalization is represented by new stock certificates issued in the same proportions as the old?**

## THIRD POINT.

**The stock dividend is in reality not a dividend at all. It is a mere certified expression of an undivided surplus and its capitalization.**

**Whatever gain there may be in either case to the stockholder is a capital gain.**

**Capital gains (being mere increases in valuation) are not income until realized.**

**The gains that come with stock dividends when stock is sold are realized capital gains—the same in nature and similarly taxable as those gains that are made with any stock that is sold at an advance. Inasmuch as undivided corporate earnings cannot be taxed as income against the stockholder the stock certificates issued with respect of such earnings may not be so taxed, until the gain be realized by the stockholder through sale of his stock.**

The proponents for the treatment of stock dividends as income do not altogether agree upon the grounds of the faith that is in them.

Thus some courts consider that a stock dividend is like a cash dividend with an option to subscribe to an equal amount of new stock—and so by calling it a cash dividend, though no cash passes, they impute to it the quality of cash income (see *Tax Comm'r* v. *Putnam*, 227 Mass., 522, also the *Swan* case, *infra*).

The Attorney General on the other hand, basing his case on what we consider the erroneous *dictum*

of the *Hubbard* case, is obliged to concede that a stock dividend is like an undivided corporate surplus.

But he argues that because undivided corporate profits were thought fifty years ago to be taxable as against the stockholders, so may those profits now be similarly taxed when represented by new stock certificates. Or, as he puts it, the right to tax undivided profits "could not be destroyed by the issuance of stock certificates to represent these undivided profits."

Thus far we agree with him in his analysis of what the stock dividend really is. But his conclusions as to its taxability fail to follow because the *Hubbard* case (as shown *supra*) has been overruled in fact by the *Pollock* case and in principle by other rulings of this court and is contrary to sound law and sound economics generally.

And, because further, whilst it is perfectly true that at any instant of time a stock dividend is similar to the undivided profits which have occasioned it—it is also true that the attempt in Chapter 173, Laws 1864, was to tax corporate earnings for the actual year when earned, whilst the stock dividends here being considered present a case of taxing the undivided corporate earnings which they represent for the year after they had been earned and when they had really become capital—and when the corporation itself had already paid its income tax on these very earnings.

With the failure of the *Hubbard* case to support him, the Attorney General's argument falls to the ground.

But it remains true as he admits that a stock dividend is like an undivided corporate surplus—and since the latter is not taxable as income of the

stockholder, it follows that the former cannot be.

**The other and opposing view, that a stock dividend is like a cash dividend with a right to subscribe to new stock is easily disposed of on analysis.**

This is the view maintained in *Swan Brewery Co., Ltd.*, v. *The King*, Law Reports (1914) A. C., 231, and in *Tax Commissioner* v. *Putnam*, 227 Mass., 522, cases both decided before the recent tax decisions of this Court and in conflict with them, and cases both occurring in jurisdictions where there was no constitutional limitation of the taxing power.

Corporations sometimes do declare a cash dividend and give also a right to subscribe to new stock.

When they do this, stockholders have three courses open to them after receipt of their cash.

1. They may keep the cash and refuse to subscribe, and this they will do in case the conditions should become unfavorable or the stock decline to par or below as frequently happens in these cases, or

2. They may keep their cash dividend and sell their rights to subscribe in case these command a premium. In which case they make a realized gain in addition to their cash dividend which is taxable as income, or

3. They may subscribe and hold the new stock and thus keep up their former percentage of stock control and of right to future dividends.

In the case of a stock dividend pure and simple, this last is the only course open to the stockholder. He is given no choice whatsoever—no power of disposal whatsoever over any new thing.

The theory we are considering ignores the difference between giving a stockholder cash with three

options—and giving him no cash and no option. Notwithstanding the *Swan* case and the *Putnam* case, the stock dividend gives the stockholder no cash and no option

Of course, in either case the stockholder may sell stock. And when he does so his profits will constitute income.

It is a figment of the imagination to assert that two things so radically different are in reality the same.

Not only is the view thus entertained in the *Swan* case and the *Putnam* case directly contradicted by *Gibbons* v. *Mahon* and *Towne* v. *Eisner,* it is also contradicted by the unifying principle which led to superficially contradictory results in *Lynch* v. *Hornby* (*supra*) and *Towne* v. *Eisner* (*supra*).

In both these cases dividends had been declared after March 1, 1913, out of corporate earnings that had been accumulated before that date, but in *Lynch* v. *Hornby* the dividend was made in cash whilst in *Towne* v. *Eisner* the so-called dividend was made in stock. This Court held that the cash dividend, though accumulated from earnings made before the Sixteenth Amendment, was income to the stockholder for the year 1914 when received by him; whilst it also held in *Towne* v. *Eisner* that the stock dividend distributed in 1914 out of earnings accumulated before the Sixteenth Amendment was not income but capital. The unifying principle which produced these opposite results was the distinction between capital and income—a cash dividend, unless in liquidation, being always income and a stock dividend being always capital. This negatives in the most direct and positive way the false analysis employed in the *Swan* case and the *Putnam* case,

which would liken the stock dividend in any regard whatsoever to a cash dividend. A stock dividend, therefore, is plainly not like a cash dividend with a right of subscription to new stock.

The government's other analysis is the correct one, viz.: that undivided profits and stock dividends are intrinsically the same thing as regards the stockholder and their effect on his income.

His gain in both cases is an inchoate, contingent, unrealized, unseparated gain giving him nothing new whatsoever to control or dispose of.

His gain is a capital gain. As was said in *Gibbons* v. *Mahon* (*supra*):—"* * * accumulated surplus * * * being part of its corporate property, it follows that the interest therein represented by each share is capital and not income of that share."

His interest in the company and in all its property is absolutely unchanged in either case.

> "A stock dividend really takes nothing from the property of the corporation and adds nothing to the interests of the shareholders. Its property is not diminished and their interests are not increased. After such a dividend, as before, the corporation has the title in all the corporate property; the aggregate interests therein of all the shareholders are represented by the whole number of shares; and the proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original shares together representing the same proportional interest that the original shares represented before the issue of the new ones."
>
> *Gibbons* v. *Mahon*, 136 U. S., 549.

> "If the sum had been carried from surplus to capital account without a corresponding issue of stock certificates, which there was noth-

ing in the nature of things to prevent, we do not suppose that anyone would contend that the plaintiff had received an accession to his income. Presumably his certificate would have the same value as before. Again, if a certificate for $1,000 par were split up into ten certificates each for $100, we presume that no one would call the new certificates income. What has happened is that the plaintiff's old certificates have been split up in effect, and have diminished in value to the extent of the value of the new."

*Towne* v. *Eisner,* 245 U. S., 418, 426.

And Prof. Seligman puts it the same way when he says: "The stock dividend is like an increased surplus: it is not like a cash dividend. In fact a stock dividend is not a dividend at all in the sense in which a cash dividend is a dividend. What is most important above all is he (the stockholder) is no richer than he would have been if there had been no dividend at all, but a simple distribution to surplus." (cf. Prof. Seligman's article *supra* at pp. 534 and 535 of the Review or at page 81 of the reprint herewith.)

For the foregoing reasons, it is respectfully submitted that the judgment of the District Court was correct and should be affirmed.

GEORGE W. WICKERSHAM,
CHARLES ROBINSON SMITH,
*Amici Curiae.*



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IN THE

# Supreme Court of the United States,

OCTOBER TERM, A. D. 1918.

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MARK EISNER, COLLECTOR, ETC.,
*Plaintiff-in-Error,*

*against*

MYRTLE H. MACOMBER,
*Defendant-in-Error.*

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IN ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF NEW YORK.

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## BRIEF AND ARGUMENT FOR DEFENDANT-IN-ERROR.

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CHARLES E. HUGHES,
GEORGE WELWOOD MURRAY,
*Counsel for Defendant-in-Error.*

The Evening Post Job Printing Office, Inc., 156 Fulton St., N. Y.

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IN THE

# Supreme Court of the United States,

## October Term, A. D. 1918.

No. 941.

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MARK EISNER, Collector of United States Internal Revenue for the Third District of the State of New York,

Plaintiff-in-Error,

AGAINST

MYRTLE H. MACOMBER,

Defendant-in-Error.

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In Error to the District Court of the United States for the Southern District of New York.

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## STATEMENT OF THE CASE.

This is a writ of error to review the final judgment in favor of the plaintiff (defendant-in-error here) for the recovery of a tax held to be illegally assessed under the Income Tax Law of 1916.

The judgment was entered upon the overruling of a demurrer to the complaint.

The facts set forth in the complaint, and admitted by the demurrer, are in substance as follows:

On January 1, 1916, the Standard Oil Company of California had capital stock issued and outstanding to the amount of $49,686,656. On that date the Company had surplus and undivided profits, which were invested in its plant, property and business required for the purposes of the Company, amounting to $44,852,263.02. Of this sum $20,353,068.34 had been earned prior to March 1, 1913, and the balance, $24,499,194.68, subsequent to that date (Transcript, p. 3).

On January 16, 1916, the directors declared a 'stock dividend' of fifty per cent. That is, additional shares of the par value of $100 each were to be issued on the basis of one-half a new share to each old share (*id.*).

The total par value of the new shares thus amounted to $24,843,327.74, and this amount was transferred from surplus account to capital stock account. This transfer embraced all the surplus earned before March 1, 1913, and so much of the remaining surplus as was necessary to equal the total par value of the new shares. As a result, 81.9257 per cent of the par value of the new shares was charged against surplus earned before March 1, 1913, and 18.0743 per cent. of the par value of new shares was charged against surplus earned after March 1, 1913, and before January 1, 1916 (*id.* pp. 4, 5).

The plaintiff, owning 2,200 shares previous to January 1, 1916, received 1,100 of these new shares (*id.* p. 4, fol. 8). It follows that 18.07 per cent. of these shares or 198.77 shares of the par value of $19,877, were charged against surplus which had been earned after March 1, 1913, and before January 1, 1916.

The defendant, purporting to act under the authority of the Treasury Department and the Act of Congress of September 8, 1916, levied a tax on the plaintiff as having received income of this amount, that is, to the extent of $19,877, the par value of the shares in question (*id.* pp. 5, 6; fols, 10, 11). There is no question as to the basis of the assessment, as alleged, but a stipulation has been made, at the instance of the Government, to the effect that "the shares of stock which were the subject of the stock dividend", as described in the complaint, "were assessed by the Commissioner of Internal Revenue at the par value thereof" (*id.* p. 10, fol. 20).

The tax was paid under protest and appeal was taken to the Commissioner of Internal Revenue, and, this appeal having been disallowed, this action was brought to recover the money so paid.

The complaint also alleges that while the number of shares of stock owned by each stockholder was increased by fifty per cent, the market value of each share was correspondingly decreased. For the month prior to the declaration of the stock dividend and immediately thereafter, sales of the stock were made in the open market at prices ranging from $360 to $382

per share, while after the closing of the books for the stock dividend the prices ranged from $234 to $268 per share. Two of the parent shares were thus equivalent to three of the shares held subsequent to the stock dividend. It is explicitly alleged in the complaint that "the value of the capital stock owned by each stockholder, including the plaintiff's shares, was substantially unchanged by reason of the declaration of the stock dividend and the issue of additional shares of stock" (*id.* pp. 4, 5; fol. 9).

The complaint alleges that such a tax is in violation of Article I, Section 2, clause 3, and Article I, Section 9, clause 4, of the Constitution requiring that direct taxes be apportioned according to population, and that the tax is not authorized by the provisions of the Sixteenth Amendment permitting the taxation of "incomes" without apportionment.

The applicable parts of the Income Tax Law of 1916 are found in 39 Stat. 756, Ch. 463, Part I, Section 1 (*b*):

> "In addition to the income tax imposed by subdivision (a) of this section (herein referred to as the normal tax) there shall be levied, assessed, collected, and paid upon the total net income of every individual, or, in the case of a non-resident alien, the total net income received from all sources within the United States, an additional income tax (herein referred to as the additional tax) of one per centum per annum upon the amount . . ."

"For the purpose of the additional tax there shall be included as income the income derived from dividends on the capital stock or from the net earnings of any corporation, joint stock company or association, or insurance company, except that in case of non-resident aliens such income derived from sources without the United States shall not be included."

Section 2 (*a*)

". . . the net income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever; *Provided,* that the term 'dividends' as used in this title shall be held to mean any distribution made or ordered to be made by a corporation, joint-stock company, association, or insurance company, out of its earnings or profits accrued since March first, nineteen hundred and thirteen, and payable to its shareholders, whether in cash or in stock of the corporation, joint-stock company, association, or insurance company, which stock dividend shall be considered income, to the amount of its cash value."

## SUMMARY OF POINTS.

We present the following points:

(1) The tax is sought to be laid upon the property in question solely by reason of ownership and cannot be sustained unless it is authorized by the Sixteenth Amendment.

(2) The fundamental fact is that there was no gain or income to the defendant-in-error by virtue of the receipt of the additional shares constituting the 'stock dividend.' The value of the shares held by the defendant-in-error was not increased by the increase in the number of shares. The shareholder was no richer than before.

(3) The tax cannot be sustained as a tax laid upon the shareholder's interest in the undivided profits of the corporation. Apart from the serious question of the validity of such a tax, as an income tax, that was not the scheme of the Act. It is sought to lay the tax in question upon the so-called stock dividend per se, that is, upon the mere readjustment of the evidence of a capital interest already owned.

(4) So far as the present question is concerned, the word "income" in the Sixteenth Amendment has no broader meaning than the word "income" in the Income Tax Act of 1913 under which the question arose in the Towne case.

(5) Stock dividends of the sort here in question are not income within the meaning of the Sixteenth Amendment.

## ARGUMENT.

**FIRST. The tax is sought to be laid upon the property in question solely by reason of ownership and cannot be sustained unless it is authorized by the Sixteenth Amendment.**

Before the Sixteenth Amendment there were two kinds of income with respect to taxability under the Federal Constitution.

(a) Gains and profits from "business, privileges, employments, and vocations" whether of corporations or of individuals.

*Pollock* v. *Farmers' Loan & Trust Co.*, 158 U. S. 601, 637.

A tax upon such gains and profits was an excise subject to the constitutional requirement as to geographical uniformity.

*Pollock* v. *Farmers' Loan & Trust Co.*, 158 U. S. 601, 635;
*Brushaber* v. *Union Pacific R. R. Co.*, 240 U. S. 1.

The Corporation Tax Act of 1909 fell within this category.

*Flint* v. *Stone Tracy Co.*, 220 U. S. 107.
*Stratton's Independence* v. *Howbert*, 231 U. S. 399.
*Doyle* v. *Mitchell Brothers Co.*, 247 U. S. 179, 182, 183.
*Hays* v. *Gauley Mountain Coal Co.*, 247 U. S. 189, 191, 192.

Similarly, under the Income Tax Act of 1913, the tax on mining corporations was found to be a true excise levied upon the results of the corporate business "in carrying on mining operations".

*Stanton* v. *Baltic Mining Co.*, 240 U. S. 103.

**(b) Income from real or personal property, as such, taxed by reason of ownership.**

The question involved in the *Pollock* case related to this sort of income, and it was held that as the tax was a direct tax Congress had no constitutional power to impose it without the required apportionment among the States according to population (Const., Art. I, Secs. 2 and 9). It was held that taxes on investments in corporate stocks, laid directly because of ownership, are in this class.

*Pollock* v. *Farmers' Loan & Trust Co.*, 158 U. S. 601, 637.

The Sixteenth Amendment removed the requirement of apportionment only in the case of taxes on incomes. It provides:

> "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

The history of this Amendment is well known. It was adopted for the purpose of avoiding the effect of

the decision in the *Pollock* case, and of permitting Congress to levy a tax on incomes, from whatever source derived, without apportionment.

*Brushaber* v. *Union Pacific R. R. Co.*, 240 U. S. 1, 18, 19.

It was, obviously, not the intention to authorize Congress to levy a direct tax on property, except as to income, or otherwise to amend, to qualify, or in any way to restrict the requirements which have existed ever since our Constitution was adopted, that direct taxes on property can be levied by Congress only if properly apportioned among the States.

That any attempt under the guise of an income tax law to levy an unapportioned direct tax on real or personal property, other than income, could not be sustained is evident from the statement in the opinion of the Court delivered by the Chief Justice in the case of *Brushaber* v. *Union Pacific R. R. Co.*, 240 U. S. 1, 19, as follows:

> "We say this because it is to be observed that although from the date of the *Hylton Case* because of statements made in the opinions in that case it had come to be accepted that direct taxes in the constitutional sense were confined to taxes levied directly on real estate because of its ownership, the Amendment contains nothing repudiating or challenging the ruling in the *Pollock Case* that the word direct had a broader significance since it embraced also taxes levied directly on personal property be-

> cause of its ownership, and therefore the Amendment at least impliedly makes such wider significance a part of the Constitution—a condition which clearly demonstrates that the purpose was not to change the existing interpretation except to the extent necessary to accomplish the result intended, that is, the prevention of the resort to the sources from which a taxed income was derived in order to cause a direct tax on the income to be a direct tax on the source itself and thereby to take an income tax out of the class of excises, duties and imposts and place it in the class of direct taxes."

See also,

*Peck* v. *Lowe*, 247 U. S. 165, 172.

*Southern Pacific Co.* v. *Lowe*, 247 U. S. 330, 335.

It is also apparent that Congress has not been authorized to coin at will definitions of "income" and prescribe that something which is not, in any true sense of the word, income shall be income for the purposes of taxation. Congress cannot by legislative fiat put a subject of a tax in a different category from that in which it properly belongs, for that would be to subject the constitutional restrictions to the legislative will.

In the present case there is no room for disputing the fact that the tax is levied upon property solely by virtue of its ownership. The Standard Oil Company of California had paid its taxes under the Corporation

Tax Act of 1909 and under the Income Tax Laws of 1913 and 1916. There is no pretense here that the present tax is laid upon the corporation, or by reason of any privilege or business of the corporation. The tax is levied upon the individual stockholder, simply because of his ownership of the shares in question. The tax upon these shares by virtue of the stockholder's ownership is, in the very nature of things, a direct tax which must be apportioned unless it can be said that these shares, issued in the circumstances we have stated, constitute income within the meaning of the Sixteenth Amendment. It is our contention that they do not.

**SECOND. The fundamental fact is that there was no gain or income to the defendant-in-error by virtue of the receipt of the additional shares constituting the 'stock dividend'. The value of the shares held by the defendant-in-error was not increased by the increase in the number of shares. The shareholder was no richer than before.**

The Income Tax Act of 1916 was approved September 8, 1916 (39 Stat. 756). The Act governed income received after January 1, 1916; that is, the year 1916 was the first taxable period to which the Act applied (*id.* p. 761; Sec. 8).

On January 1, 1916, Mrs. Macomber, the defendant-in-error, held 2,200 shares of the capital stock under consideration. The value of these shares as they then stood rested upon the total assets of the corporation. These assets were not segregated with respect to the company's capital as distinguished from its surplus.

The latter, quite as much as the former, was represented by investments in the business (Transcript, p. 3, fol. 6). The assets of the corporation consisted of plant, property and working capital. Mrs. Macomber's interest on January 1, 1916 (or December 31, 1915), by virtue of her ownership of the 2,200 shares, was her proportionate interest in the aggregate assets of the corporation, subject to the payment of debts.

The earnings of the corporation for the years prior to January 1, 1916 had been subject to the Corporation Tax Act of 1909 and to the Income Tax Act of 1913. Mrs. Macomber herself had been subject to the individual income tax, under the Act of 1913, upon all the taxable income she had received prior to January 1, 1916.

What remained to Mrs. Macomber as her property on January 1, 1916, after satisfaction of income taxes applicable to the period antedating January 1, 1916, constituted her capital so far as the income tax for succeeding years was concerned. Her interest as a shareholder in the aggregate assets of the corporation, as these assets stood on January 1, 1916, was a capital interest, and it is none the less to be regarded as such because, from the standpoint of corporate finance, part of the assets represented capital and part represented surplus, or because part of the surplus had been accumulated at one time and part at another time. Her capital interest on January 1, 1916, would have been no greater and no less had the corporation been or-

ganized with shares without par value as now is so frequently the case.

The question is, What has the defendant-in-error received in the year 1916 which can properly be considered to be income and hence taxable without apportionment? The Government says she has received 1,100 shares of stock. She answers that these shares of stock did not add to her wealth and in no sense constituted gain or income. The Government admits that the shares are not to be considered income so far as they are based upon surplus earned by the corporation before March 1, 1913, but that they are to be considered income to the extent of the par value of the shares that are based upon surplus earned by the corporation between March 1, 1913, and January 1, 1916. The defendant-in-error answers that this portion of the shares is no more income than the former, and that after the receipt of the shares she was left with precisely the same ownership and actual interest that she had on January 1, 1916.

This fact is not left to mere inference, however plain. It is alleged in the complaint and admitted by the demurrer. The so-called 'stock dividend' of fifty per cent. declared on January 16, 1916 (Transcript, p. 3, fol. 5) increased her number of shares from 2,200 to 3,300, but the 3,300 shares were worth no more than the 2,200. As soon as the books were closed for the stock dividend, the market value went down correspondingly (Transcript, pp. 3, 4; fols. 8, 9). The com-

plaint alleges "that the number of shares of stock owned by each stockholder was increased by fifty per cent. and at the same time the market value of each share was correspondingly decreased", and the figures are given (*id.* p. 4, fol. 9), and then follows this allegation and conceded fact:

> "That the value of the capital stock owned by each stockholder, including the plaintiff's shares, was substantially unchanged by reason of the declaration of said stock dividend and the issue of additional shares of stock" (*id.* pp. 4, 5, fol. 9).

*Non constat* that the defendant-in-error will ever realize even the market value of her shares as that value stood on December 31, 1915; certainly by receiving the additional shares she received no gain or income.

The contention of the Government, then, is that the defendant-in-error is to be deemed to have received in the year 1916, by virtue of the increase then effected in the number of her shares, income to the extent of $19,877, when in fact she received no gain or income whatever. The case is thus precisely like that described in *Towne* v. *Eisner,* 245 U. S. 418. There, in 1914, the corporation declared a 'stock dividend' of fifty per cent, that is, 15,000 shares in addition to the existing 30,000 shares, but it was held that these did not constitute gain or income to the shareholder for the reason thus stated by Mr. Justice Holmes in speaking for the Court (*id.* p. 426):

"'A stock dividend really takes nothing from the property of the corporation, and adds nothing to the interests of the shareholders. Its property is not diminished, and their interests are not increased. . . . The proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original shares together representing the same proportional interest that the original shares represented before the issue of the new ones.' *Gibbons* v. *Mahon*, 136 U. S. 549, 559, 560. In short, the corporation is no poorer and the stockholder is no richer than they were before. *Logan County* v. *United States*, 169 U. S. 255, 261. If the plaintiff gained any small advantage by the change, it certainly was not an advantage of $417,450, the sum upon which he was taxed. It is alleged and admitted that he receives no more in the way of dividends and that his old and new certificates together are worth only what the old ones were worth before. If the sum had been carried from surplus to capital account without a corresponding issue of stock certificates, which there was nothing in the nature of things to prevent, we do not suppose that any one would contend that the plaintiff had received an accession to his income. Presumably his certificate would have the same value as before. Again, if certificates for $1,000 par were split up into ten certificates each, for $100, we presume that no one would call the new certificates income. What has happened is that the plaintiff's old certificates have been split up in effect and have diminished in value to the extent of the value of the new".

It is apparent that the reason that the 'stock dividend' was held not to be income in the *Towne* case was that it did not constitute income in its nature and that no governmental assertion to the contrary could alter that fact. It was because the 'stock dividend' was not income in its nature, and not because the surplus transferred to capital account had been accumulated prior to March 1, 1913, that the court was led to the decision that it was not taxable. The Act of 1913, there in question (38 Stat. 114, 166, 167) taxed income generally. If the 'stock dividend' had been income, there was nothing in the Act which could have saved it from taxation. Moreover, as it has been held by this Court, the Act of 1913 taxed dividends to shareholders although they were distributed out of earnings accumulated before March 1, 1913 (*Lynch* v. *Hornby*, 247 U. S. 339). Even though the corporation distributed, *in specie*, shares of stock of other corporations which it held in its treasury as a part of its surplus prior to March 1, 1913, the distribution thereafter and during the taxable year was held to constitute income (*Peabody* v. *Eisner*, 247 U. S. 347). In the latter case, the Court expressly distinguished such a distribution from the case of a 'stock dividend' (*id.* p. 349), manifestly because of the fact that, in the former case, a part of the corporate assets was segregated and transferred to the separate ownership of the shareholders, while, in the latter case, "the proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares

and the original shares together representing the same proportional interest that the original shares represented before the issue of the new ones". (*Towne* v. *Eisner, supra.*)

If, in the *Towne* case, the 'stock dividend' in 1914 had constituted income, although it had been based on earnings accumulated before March 1, 1913, it would unquestionably have been taxable as income under the Act of 1913 (38 Stat. 167). It was not so taxable simply because it was not income for the reason stated in the opinion. The case here is precisely the same. The shares received by the defendant-in-error in 1916 were not income in their nature; she was no richer because they were received. And not being income, they were not taxable as such.

**THIRD. The tax cannot be sustained as a tax laid upon the shareholder's interest in the undivided profits of the corporation. Apart from the serious question of the validity of such a tax, as an income tax, that was not the scheme of the Act. It is sought to lay the tax in question upon the so-called 'stock dividend' *per se*, that is, upon the mere readjustment of the evidence of a capital interest already owned.**

It is evident that the Government chiefly relies upon the case of *Collector* v. *Hubbard,* 12 Wall. 1, but we submit that the Government can find no support in the ruling of that case for the tax attempted here.

The *Hubbard* case arose under section 117 of the Act of 1864 (13 Stat. 281, 282), which provided that

"the gains and profits of all companies", other than those otherwise taxed, should "be included in estimating the annual gains, profits or income of any person entitled to the same, whether divided or otherwise."

(1) It may be at once observed that, even if it were assumed (as we do not admit) that an interest in undivided profits of the corporation may be taxable as gain or income to the shareholder, it does not follow that additional shares *per se*, constituting a 'stock dividend', are gain or income. The proposition is a plain *non sequitur*. The two subjects are distinct. The one is an interest in undivided profits; the other is a readjustment of the evidence of an interest already owned. If the additional shares, constituting a 'stock dividend', are income *per se*, then it is unnecessary to consider whether an interest in undivided profits is or is not income. And if additional shares, as a readjustment of the evidence of an existing interest, are not income *per se*, then they do not become income because an interest in undivided profits might have been regarded as income when that interest accrued.

If shares constituting a 'stock dividend' are sought to be taxed as income *per se*, the question arises whether they can be regarded as income. On the other hand, if the tax is sought to be supported as a tax upon an interest in undivided profits, the question necessarily arises whether that is the scheme of the taxing act; whether that interest in undivided profits is, in truth, the subject of the tax and is taxable as such.

For example, in *Lynch* v. *Hornby, supra,* the shareholder's interest in undivided profits accumulated prior to March 1, 1913, was not taxed or taxable. What was taxed was the distribution of these profits in dividends and these were taxable although paid out of the prior accumulation, because they were segregated in 1914, and were then passed into the ownership of the shareholder. Similarly, in *Towne* v. *Eisner, supra,* the interest in undivided profits accumulated before March 1, 1913, was not taxed or taxable and the subsequent issue of additional shares, in 1914, was not taxable either, because these shares, unlike the moneys in the *Hornby* case or the securities distributed in the *Peabody* case, constituted a mere readjustment of the evidence of an interest already owned and did not constitute gain or income to the shareholder.

In the present case, as we deem it to be clear (for reasons hereinafter pointed out, *post,* pp. 28-33), there was no attempt to tax an interest in undivided profits. Whether or not it could have been taxed when it accrued is immaterial. It was not taxed, and, further, at the time in question it was not taxable, as from every possible point of view that interest had already become capital and was no longer, if at any time, subject to an income tax (*post,* pp. 29-30). What was sought to be taxed here was the 'stock dividend' or additional shares *per se,* and these did not constitute gain or income.

(2) It is to be noted that the endeavor of the Act of 1864, under which the case of *Collector* v. *Hubbard*

arose, was to insure the payment of the tax upon the earnings of the corporation (see *Gibbons* v. *Mahon*, 136 U. S. 549, 560). Under the Act of 1864 there were three provisions relating to taxes upon corporate earnings. Section 122 (13 Stat. 284-285) related to railroad, canal and turnpike companies and provided for a tax of five per cent upon the amount of interest, dividends or profits. After a long-standing difference of opinion[1] it was finally decided that this was essentially an excise tax on the business of the described corporations (*Railroad Company* v. *Collector*, 100 U. S. 595, 598; *United States* v. *Erie Railway Co.*, 106 U. S. 327, 330). By section 120 of the same Act (13 Stat. 283, 284) provision was made for a similar tax with respect to the earnings of banks, trust companies and insurance companies. Section 117, which was before the Court in the *Hubbard* case, related to the earnings of all other companies, that is, all companies except those above specified, and embraced the manufacturing corporations, the earnings of which were there in question. Section 117 was thus intended to reach corporate earnings not otherwise taxed. As the Attorney General said in his argument (12 Wall. p. 8), after referring to

[1] *Barnes* v. *The Railroads*, 17 Wall. 294, 309, 319; *United States* v. *B. & O. R. R. Co.*, 17 Wall. 322; *Stockdale* v. *Insurance Companies*, 20 Wall. 323, 329, 337; *Bailey* v. *Railroad Co.*, 22 Wall. 604; *Railroad Company* v. *Collector*, 100 U. S. 595; *Bailey* v. *Railroad Co.*, 106 U. S. 109; *United States* v. *Erie Railway Co.*, 106 U. S. 327, 329, 330, 331; *Memphis & Charleston R. R. Co.* v. *United States*, 108 U. S. 228, 234. See *United States* v. *Louisville & N. R. R. Co.*, 33 Fed. 829, 831, 832; *Pollock* v. *Farmers Loan & Trust Company*, 157 U. S. p. 578.

the different methods employed in these sections of the Act of 1864: "In all cases the entire annual gains and profits of every corporation, divided or undivided, seem to be within the aim and purview of the statute as objects of taxation". And as was said by Mr. Justice Clifford (*id.* p. 18): "Congress did direct that all such gains and profits, *whether divided or otherwise,* should be included in estimating the annual gains, profits, or income liable to taxation under the provisions of that act".

We find no constitutional question raised in the *Hubbard* case. The corporate earnings there in question were the earnings of the year for which the shareholder was making his return. An attempt to tax the shareholder upon his interest in undivided corporate profits accumulated in prior years, after both the corporation and the shareholder had paid all income taxes for which they were then liable, was in no way involved. The actual result was simply to tax all the gains and earnings of the corporation for the tax year. It does not appear that the *Hubbard* case was ever cited in any Federal Court, except upon questions of procedure, prior to 1917. As was said by this Court in *Southern Pacific Company* v. *Lowe,* 247 U. S. 330, 336, the decision in the *Hubbard* case was based "upon the very special language" of section 117 of the Act of 1864. And, in any event, that case furnishes no support for the tax sought to be assessed here.

(3) The point of view taken in the opinion in the *Hubbard* case is clearly indicated in the concluding sentence, in which Mr. Justice Clifford remarks:

> "Annual gains and profits, whether divided or not, are *property*, and, therefore, are taxable". (12 Wall. p. 18; italics ours.)

The same course of reasoning appears in the earlier statement of the opinion:

> "Regarded as an incident to the shares, undivided profits are property of the shareholder, and as such are the proper subject of sale, gift, or devise" (*id.*).

This emphasis upon the fact that the interest of the shareholder in the corporate surplus was *property* is significant, and a consideration of the course of judicial opinion makes it quite evident that this was thought to be sufficient to support the tax, without drawing the distinction between what was a mere *"capital"* interest not realized, and that which could be regarded, properly speaking, as *"income"* to the shareholder. It is not too much to say that at that time a tax upon personal property (and the interest of a shareholder in the assets of the corporation is personal property), was not regarded as a *direct* tax, in the constitutional sense. Certainly, in the light of our constitutional history, it cannot be assumed that it was supposed by the Court, in deciding the *Hubbard* case, that such a tax was a direct tax and ran

counter to the constitutional provision as to apportionment. No such question was presented to the Court.

In the *Hylton* case (3 Dall. 171), it was held that a tax upon carriages, laid without apportionment, was constitutional because not a direct tax. The implications of this decision had general acceptance. When, in 1861, it was proposed to levy a direct tax, by apportionment, on personal property, a committee of the House of Representatives reported that under the *Hylton* case it could not be done (see 158 U. S. p. 710). It was pointed out in the dissenting opinion of Mr. Justice White in the *Pollock* case that the view had long been held that direct taxes in the constitutional sense only embraced taxes on real estate and capitation taxes (157 U. S. pp. 636, 639; see *Pacific Insurance Co.* v. *Soule*, 7 Wall. 433, 443; *Veazie Bank* v. *Fenno*, 8 Wall. 533, 541, 546). When the *Hubbard* case was decided it might well have been, and probably was, taken for granted in the absence of contention to the contrary that *personal property* could be taxed without apportionment, and that when it was found that the subject of the tax in that case was property, as Mr. Justice Clifford said, the argument against the tax was answered. The decision was nearly twenty-five years before the controversy and decision in the *Pollock* case.

In the *Pollock* case (158 U. S. 601) it was ruled that the word *"direct"* had a broader significance "since it embraced also taxes levied directly on personal property because of its ownership" (*Brushaber* v. *Union Pacific R. R. Co.*, 240 U. S. 1, 19). The Six-

teenth Amendment "at least impliedly makes such wider significance a part of the Constitution" and the purpose of the Amendment was thus "not to change the existing interpretation except to the extent necessary to accomplish the result intended, that is, the prevention of the resort to the sources from which a taxed income was derived in order to cause a direct tax on the income to be a direct tax on the source itself and thereby to take an income tax out of the class of excises, duties and imposts and place it in the class of direct tax" (*Brushaber* v. *Union Pacific R. R. Co., supra*).

It now becomes necessary, as evidently it was thought not to be necessary in the *Hubbard* case, to distinguish between a tax upon *personal property* (including investments in corporate stock), which under the *Pollock* case is a direct tax, and the *income* from personal property which is taxable, without apportionment, by virtue of the Sixteenth Amendment. It is plain that the country has entered upon a permanent policy of income taxation, and it is absolutely necessary that "income" within the meaning of the Sixteenth Amendment should be distinguished from the "capital" interest of the taxpayer. In no other way, as we conceive it, can the Constitution be properly applied. The distinction between what is the property and income of the corporation, and what is the property and income of the shareholder, is a vital one.

It is evident that the interest of a shareholder, by virtue of the ownership of his shares, is a *capital*

interest. It is a single interest in the aggregate assets of the corporation subject to the payment of debts. The shareholders are not the owners of the property, profits or the invested accumulations of the corporation. The interest of each shareholder in the assets of the corporation is one that can only be enjoyed in possession in case there is a winding-up or liquidation. The fact that the value of the share interest may be greater at one time than another in no way changes the nature of the interest. The shareholder has the right to vote, to receive dividends, and on liquidation to receive his proportionate part of the surplus that may remain after debts are paid. He has the right to have the assets of the corporation properly employed in the corporate enterprise. He may transfer his right by sale. Except as he receives dividends, he has no segregated interest in corporate surplus or undivided profits. His interest, by virtue of stock ownership, is always his proportionate right with respect to the aggregate assets of the corporation, subject to the payment of all liabilities, and he has no divisible interest in the profits which the corporation holds, without distribution, and invests in its plant and business. The shareholder has simply his share, his interest, in the corporate enterprise. The corporation must, of course, pay its income tax upon its profits, but there is no income to the shareholder unless he receives it. His share interest is a "capital" interest.

When the question of the nature of the shareholder's interest in undivided profits came before this

Court in *Gibbons* v. *Mahon* (136 U. S. 549) the question was carefully considered and explicitly determined. The Court pointed out the distinction between the money earned by the corporation, and the shareholder's income, and ruled expressly that the interest of the shareholder in the accumulated earnings of the corporation, as a part of his share interest, was capital and not income, so long as the earnings were held and invested by the corporation as a part of its corporate property.

It is evident that in *Gibbons* v. *Mahon, supra,* the former expressions of this Court, including those in the case of *Bailey* v. *Railroad Company* (22 Wall. 604), had been carefully examined (136 U. S. p. 560). It was remarked that the opinion of Mr. Justice Clifford in the *Bailey* case contained "some general expressions which, taken by themselves, might seem to ignore the settled distinction, (affirmed by this court in earlier and later cases above cited,) between the property of the corporation and the interests of the shareholders". Summarizing its views, the Court said in the *Gibbons* case, speaking through Mr. Justice Gray (*id.* pp. 557, 558):

> "The distinction between the title of a corporation, and the interest of its members or stockholders, in the property of the corporation, is familiar and well settled. The ownership of that property is in the corporation, and not in the holders of shares of its stock. The interest of each stockholder consists in the right to a proportionate part of the profits whenever

dividends are declared by the corporation, during its existence under its charter, and to a like proportion of the property remaining, upon the termination or dissolution of the corporation, after payment of its debts. Van Allen v. Assessors, 3 Wall. 573, 584; Delaware Railroad Tax, 18 Wall. 206, 230; Tennessee v. Whitworth, 117 U. S. 129, 136; New Orleans v. Houston, 119 U. S. 265, 277.

"Money earned by a corporation remains the property of the corporation, and does not become the property of the stockholders, unless and until it is distributed among them by the corporation. The corporation may treat it and deal with it either as profits of its business, or as an addition to its capital. Acting in good faith and for the best interests of all concerned, the corporation may distribute its earnings at once to the stockholders as income; or it may reserve part of the earnings of a prosperous year to make up for a possible lack of profits in future years; or it may retain portions of its earnings and allow them to accumulate, and then invest them in its own works and plant, so as to secure and increase the permanent value of its property. . . .

"Reserved and accumulated earnings, so long as they are held and invested by the corporation, being part of its corporate property, it follows that the interest therein, represented by each share, is capital, and not income, of that share, as between the tenant for life and the remainderman, legal or equitable, thereof."

And, in the opinion in *Towne* v. *Eisner, supra,* referring to the 'stock dividend' there under considera-

tion and to the views expressed in *Gibbons* v. *Mahon* this Court said:

> **"Notwithstanding the thoughtful discussion that the case received below we cannot doubt that the dividend was capital as well for the purposes of the Income Tax Law as for distribution between tenant for life and remainderman. What was said by this court upon the latter question is equally true for the former."**

We submit, therefore, that the holding of the Court in the *Hubbard* case cannot be regarded as establishing the proposition that in the light of the Sixteenth Amendment the undistributed earnings of a corporation which have been invested in its plant and property and upon which the shareholder may never actually realize anything, are to be regarded as income to the shareholder. That proposition, we submit, would be wholly untenable; it would be in the teeth of any proper definition of "income" and of the established principles of law governing corporations and the rights of shareholders.

(4) There is in the present case, however, no attempt to tax an interest in undivided profits, and, in any event, the shareholder's interest in the profits of the corporation, accumulated in prior years, was not taxable. The scheme of the Income Tax Acts of 1913 and 1916 is clear.

The Act of 1913 (38 Stat. 166) did not attempt to lay any tax as against the shareholder upon an interest

in the undivided profits of the corporation, save in a single case. That case was where there was a fraudulent withholding of profits evidenced by an accumulation beyond the reasonable needs of the business and certified to be such by the Secretary of the Treasury (See *Southern Pacific Co.* v. *Lowe,* 247 U. S. 330, 336). No such case is presented here. Apart from this exceptional case, the corporation was to be taxed on its earnings, and, for the purpose of the additional tax only, the shareholder was taxed upon his dividends. The Act of 1913 manifestly applied to all dividends that could be considered to be income (38 Stat. 167) and did not apply to so-called 'stock dividends' simply because they were not income. The Act of 1913 governed the years 1913, 1914 and 1915 and was repealed on September 8, 1916, by the new Act then approved.

The Act of 1916 (39 Stat. 756), like the former Act, did not attempt to tax shareholders upon an interest in the undivided profits of the corporation, save in the case of a fraudulent withholding certified to be such (*id.* p. 758; sec. 3). This Act was to operate for the year 1916. It had no relation to prior years. It did not attempt to tax any income for years prior to 1916, and, in the nature of things, it did not, and could not, attempt to reach any interest in the undivided profits of corporations earned in prior years. Such interests, both as to corporations and shareholders, the income taxes having been paid for the years in which the profits were earned, were certainly no longer income, or subject to taxation as income, in subsequent years, but constituted

*capital* with reference to the income taxes of such subsequent years. "Capital", as the Government asserted in the *Towne* case (245 U. S. p. 422), "represents the wealth or property of a person at a given instant of time." And 'capital' with reference to the Income Tax Act of 1916, and income thereunder for 1916, represents the wealth or property of a person on January 1, 1916. "Income" is what is received as such during the taxable period. What was income in 1915, and taxable as such, was no longer income in 1916, the next succeeding tax period. To hold otherwise would mean that Congress could now levy a tax of fifty per cent., or any per cent., on the income of 1914. Should Congress so attempt, it would be met by the obvious proposition that the income of 1914 had paid its tax and that the property then remaining was capital and not income with reference to a tax imposed now.

The Act of 1916, in its reference to 'stock dividends', manifestly attempted to treat such issues of shares as income *per se*. There is no basis in fact or law, we submit, for the argument that Congress was attempting to reach, or could then reach, the interest of a shareholder in undivided profits, which, if income at all, was income only in years prior to 1916. If the 'stock dividend' was income *per se*, it was taxable as such; but if it was not income, it was not taxable as such. The tax upon the shares cannot be sustained as a tax upon a previously accrued interest in undivided profits. That interest was not taxable and there was no attempt to lay such a tax.

This is clearly apparent from the following considerations:

(*a*) Congress had before it the question of taxing, as against shareholders, interests in the undivided profits of the corporation, in framing both the Act of 1913 and that of 1916. But, in each Act, such a tax was limited to the interests in undivided profits where these had been fraudulently withheld. No tax was laid upon the interests of the shareholder in undivided profits where these were properly invested in plant or were needed as working capital for the company's business. This must be deemed to be deliberate.

Now, what happened when a corporation thus invested its undivided profits? The corporation paid its annual income tax upon its earnings; and there was no tax laid upon the shareholder as to the interest in the profits thus invested. Accordingly, at the end of the tax year, what the corporation had left was its capital, so far as the Income Tax Law for the succeeding tax year was concerned. The distinction between corporate capital and corporate surplus had in that aspect no significance. Similarly, what the shareholder had left at the end of the tax year was his capital; and, so far as it represented an interest in the aggregate assets of the corporation, it was equally his capital whether these assets represented corporate capital or corporate surplus, or whether the surplus had been accumulated in the preceding year or earlier. What was subsequently taxable was what he received as income, including what his

capital might earn and what might be paid him in dividends. And Congress, in attempting to treat the subsequent 'stock-dividend' as income, did not, and could not, go back to tax what had become a capital interest.

(*b*) To treat the attempted tax on 'stock dividends' as an effort to pursue the policy of taxing interests in undivided profits, would be to impute to Congress the intent to perpetrate a gross inequity.

Corporations throughout the land have invested their surplus earnings in plants, in betterments and extensions, and employed these earnings as working capital, but the shareholders are not taxed upon their interests therein. In short, in the absence of a 'stock dividend' it is admitted that no such interest of a shareholder is taxed where the corporate surplus has been properly invested in the plant or business of the corporation. Instances of such investments of surplus are very numerous and vastly outnumber cases of 'stock dividends' which are relatively few.

If Congress had intended to tax interests of shareholders in undivided profits, assuming for the moment that Congress could do this, Congress undoubtedly would have done so. It may be supposed that, if Congress had adopted such a policy, Congress would lay that tax with a decent regard for fairness and at least would tax the shareholders in all corporations of the same class according to their respective interests in undivided surplus.

It is plain that a mere tax on 'stock dividends' would

never be laid in pursuance of a policy of taxing shareholders upon their interests in corporate surplus which had been invested in the corporate plant or business, for that would mean that, unless there was a 'stock dividend', the property sought to be reached, or the increment or gain sought to be reached, would not be taxed at all. On the other hand, such a tax laid simply in the case where a 'stock dividend' was issued would mean a grossly unequal tax reaching shareholders in only a few corporations, and which, from the standpoint of an effort to tax interests in undistributed surplus, would be obviously partial, inadequate and lacking in ordinary good sense.

Again, such an effort, limited to the case of 'stock dividends', would never reach shareholders in corporations having stock without par value. These important business corporations would be immune, and although the professed object was to reach interests in undivided surplus, these corporations might hold their surplus for business purposes to any extent without subjecting their shareholders to the tax.

The tax which Congress did lay is not to be sustained by invoking a tax which Congress did not lay or attempt to lay.

Instead of following the method of the Act of 1864, Congress taxed corporations upon their earnings and did not seek to tax shareholders upon interests in undivided surplus properly invested.

Congress undertook to tax 'stock dividends', not in

a fatuous endeavor thus to impose a tax, which would operate unequally and in a limited field, upon interests in undisturbed surplus, but in the view that 'stock dividends' or shares thus issued constituted income *per se*. If 'stock dividends' *per se* do constitute income, then Congress achieves its end; but if *per se* they do not constitute income, then Congress could not make them income by describing them as such. Congress is constitutionally debarred from taxing "capital" interests under the guise of "income", and it cannot treat that as income which is a mere readjustment of the evidence of a capital interest and makes the shareholder no richer.

The Government discloses what we cannot but regard as the fallacy of its contention when it says in its argument (Govt. brief, p. 19):

> "It must be remembered that it is not claimed that a stock dividend is always and necessarily income. The illustrations used above show that a stock dividend may be declared out of earnings and gains which had become the capital of both the corporation and the stockholder before the tax law became effective, and hence do not represent a gain accruing to the stockholder during the taxable period. The insistence simply is that such dividends are income whenever they, in fact, represent an actual gain to the stockholder during the taxable period."

In short, it is here recognized that corporate earnings may have become the capital of both the corpora-

tion and the shareholder before the tax law became effective, and hence do not represent a gain accruing to the shareholder during the taxable period; and it is said that 'stock dividends' are income whenever they do represent an actual gain to the shareholder during the taxable period and not otherwise.

But it conclusively appears that the 'stock dividend' in this case did not represent any gain to the shareholder during the taxable period.

The Government seems to think that because the Sixteenth Amendment went into effect March 1, 1913, or shortly before, that any succeeding period of years is "the taxable period."

But the Act of 1913 had its taxable periods, to-wit, each calendar year (unless there was a different fiscal year for the individual or corporation concerned), and thus there were the separate taxable periods of the year 1913, of 1914, and of 1915, under that Act. In September, 1916, Congress passed another tax law which was to govern the year 1916 and later years until changed. Within the precise limits of the Government's statement, the gains and earnings in question *had* become "the capital of both the corporation and stockholder" before the tax law in question became effective": that is, before the first tax year or period to which it related, that is, before January 1, 1916.

Nor does it make any difference when the particular tax law became effective. The point is as to the tax year, or the taxable period; and earnings or profits, or

corporate surplus, which have paid their tax for a given taxable period, become "capital" both as to the corporation and the shareholder at the end of that period, and, according to the Government's own statement, the subsequent 'stock dividend' based thereon is not income.

To repeat, the tax upon the 'stock dividend' in this case is not a tax, and cannot be a tax, upon an interest in undivided profits. It is an attempted tax upon shares, which are a mere readjustment of the evidence of a capital interest already owned and do not constitute income, and the provision of the Act could not alter that fact.

**FOURTH. So far as the present question is concerned, the word "income" in the Sixteenth Amendment has no broader meaning than the word "income" in the Income Tax Act of 1913 under which the question arose in the *Towne* case.**

In the *Towne* case (245 U. S. 418), the Government endeavored to dismiss the writ of error on the ground that no constitutional question was involved. The plaintiff-in-error in that case insisted that the tax law as construed by the District Court was unconstitutional. The Court held that the fact that the construction of the statute was involved did not eliminate the constitutional question, for while the Government "keeps the money it opens the question whether the Act construed as it has construed it can be maintained" (*Towne* v. *Eisner, supra*).

It is clear, however, that if a 'stock dividend' constituted income, it was taxed by the Act of 1913 which embraced "the entire net income arising or accruing from all sources" (38 Stat. 166). The text appears in the margin.[1] The Act included "dividends" without

[1] "A. Subdivision 1. That there shall be levied, assessed, collected and paid annually upon *the entire net income* arising or accruing *from all sources* in the preceding calendar year to every citizen of the United States, whether residing at home or abroad, and to every person residing in the United States, though not a citizen thereof, a tax of 1 per centum per annum upon such income, except as hereinafter provided; and a like tax shall be assessed, levied, collected, and paid annually upon *the entire net income* from all property owned and of every business, trade, or profession carrried on in the United States by persons residing elsewhere.

"Subdivision 2 (providing for the surtax).

. . . . . .

"Every person subject to this additional tax shall, for the purpose of its assessment and collection, make a personal return of his *total net income from all sources*, corporate or otherwise, for the preceding calendar year.

. . . . . .

"B. That, subject only to such exemption and deductions as are hereinafter allowed, the *net income* of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, *dividends*, securities, or the transaction of any lawful business carried on for gain or profit, or *gains or profits and income derived from any source whatever*, including the income from but not the value of property acquired by gift, bequest, devise, or descent: . . .

"That in computing net income for the purpose of the normal tax there shall be allowed, as deductions: . . . seventh, the amount received as dividends upon the stock or from the net earnings of any corporation, joint stock company, association, or insurance company which is taxable upon its net income as hereinafter provided; . . .

. . . . . .

"D. . . . *Provided further*, That persons liable for the normal income tax only, on their own account or in behalf of another, shall not be required to make return of the income derived from dividends on the capital stock or from the net earnings of corporations, joint-stock companies or associations, and insurance companies taxable upon their net income as hereinafter provided" (38 Stat. 166-168. Italics ours).

qualification and plainly covered every dividend which could be considered to be income.

It was in this view that it was held in *Lynch* v. *Hornby* that the Act reached extraordinary dividends from surplus which had been accumulated before March 1, 1913, even where the surplus embraced the increased value of the property of the corporation. While the distribution was an extraordinary one, the shareholder had received the money and it was held to be within the comprehensive words of the Act covering income from all sources. The Court expressly overruled the contention that the words of the Act of 1913 could be read in connection with the explicit provision of the later Income Tax Act of 1916 so as to exclude dividends declared out of earnings or profits which had accrued prior to March 1, 1913. The later Act of 1916 expressly excluded dividends out of earnings or profits which had accrued before March 1, 1913, but the Court held that no such qualification could be read into the broad words of the Act of 1913 (*Lynch* v. *Hornby*, 247 U. S. 344-345). The only ground for holding the 'stock dividend' in the *Towne* case not to be taxable, although the shares were issued in the year 1914 under a corporate resolution of December, 1913, was that the 'stock dividend' was not income in its *nature*. And this being so, it necessarily follows that it was just as much excluded from the authority conferred by the Sixteenth Amendment as it was from the provision of the Act of 1913. If Congress had the power to tax the 'stock dividend', because

the 'stock dividend' was *income,* there is no escape from the conclusion that it did tax it in the Act of 1913. And, if the 'stock dividend' in the *Towne* case was not within that Act, it was only by virtue of the fact that it was not income in truth. The Court had jurisdiction to determine the meaning of the word 'income' both as used in the statute and as used in the Constitution, but in determining that the 'stock dividend' did not fall within the description of income, it based its conclusion upon reasoning which had no reference to the special time or circumstance of the statute but to the nature of the property itself, and its conclusion that the 'stock dividend' was not income was thus based upon a ground applicable both to the Constitution and to the statute. In fact the statute was enacted immediately after the Sixteenth Amendment was adopted and manifestly with the same intent.

And here it may be pertinent to observe, with respect to the decision in *Swan Brewery Company, Limited,* v. *The King,* Law Reports [1914] A. C. 231, that the Dividends Duty Act of 1902 of Western Australia, there under consideration, was in this respect like our Income Tax Act of 1913. The Australian Act of 1902 taxed "dividends" as our Income Tax Act of 1913 taxed "dividends". Similarly, the Massachusetts Act, which was the subject of decision in *Tax Commissioner* v. *Putnam,* 227 Mass. 522, arose under a statute which used the term "dividends" without any special mention of 'stock dividends' and the Court referred in its opinion to the provisions of the Federal Income Tax Act of

1913 (*id.* p. 528), the statute being similar, so far as the present question is concerned. The decision in the *Swan Brewery* case was rendered over three years before, and the decision in Massachusettts six months before, the decision of this Court in *Towne* v. *Eisner.*

These earlier decisions, cited by the Government, can in no way affect the decision or reasoning of this Court in the *Towne* case, for this Court rested its decision on the fundamental and clear proposition that that was not income which left the shareholder no richer than before, but merely readjusted the evidence of an interest already owned,—a proposition which the Courts upon whose decisions the Government relies saw fit to ignore.

**FIFTH, 'Stock dividends' of the sort here in question are not income within the meaning of the Sixteenth Amendment.**

In view of the explicit ruling of this Court as to the nature of a 'stock dividend', we should suppose that the question was no longer open to argument. But in view of the statements contained in some of the opinions of other courts, which the Government cites, we shall briefly review the considerations which, as we view it, lead to the conclusion that 'stock dividends' are not income. And if they are not income in the sense that they make the shareholder richer than he was before, it can hardly be contended that they should be regarded as income within the meaning of the constitutional provision.

The situation here presented is a typical one and the facts to which the question is addressed are familiar.

A corporation is not bound to distribute all its earnings in dividends. The directors may properly decide to use a portion of the earnings for the development of business, for the extension of plant, for betterments and for working capital. The undivided surplus of a corporation is not, normally, idle money; it is, normally, invested money. It is money invested in property, or embarked in the corporate enterprise; that is the reason it is not paid out in dividends. If the directors have not transcended the broad limits of their judgment, the shareholders cannot complain because earnings are invested instead of being distributed.

The interest of the shareholders, with respect to the property of the corporation, is not an interest in the segregated portion representing the original subscriptions; it is not an interest limited to an amount equal to the par value of their shares; it is not an interest limited to any particular portion of the corporate property, in the absence of special charter provisions, but is simply an interest in all the corporate assets. When these assets are swelled by the addition of undivided profits, the interest of the shareholders in these accumulations is precisely the same as their interest in any other property of the corporation. "The property of every company may consist of three separate distinct things, which are its capital stock, its surplus, its fran-

chise; but these three things, several in the ownership of the company, are united in the ownership of the shareholders. The share stock covers, embraces, represents all three in their totality, for it is a business photograph of all the corporate possessions and possibilities. (*People ex rel. Union Trust Co.* v. *Coleman*, 126 N. Y. 433, 438.)

When dividends are declared the amounts of the dividends are separated from the corporate property and are received by the shareholders respectively as their separate property. But until dividends separating money or property from the corporate assets in this way are declared, the shareholders continue to retain the interest in all these assets represented by their stock, the extent and value of their aggregate interests depending not upon the sums originally contributed to capital, but upon the extent and value of all the assets of the corporation, including its accumulations, after deducting liabilities. When a so-called 'stock dividend' is declared, the company does not distribute but continues to hold the property upon which the stock issue rests. Its undivided profits previously invested in the enterprise continue to be so invested. Instead of being a "dividend" in any proper sense, the effect of the action is that there shall be no dividends of the accumulations capitalized. The aggregate interests of the shareholders remain unchanged and their proportional interests remain unchanged.

Thus, a 'stock dividend', or increase of capital

stock against surplus accumulations, accomplishes two things:

(1) The amount represented by the 'stock dividend' is permanently classified so that it cannot be paid out as dividends.

(2) The number of shares is increased without affecting the title of the corporation to any part of the corporate property and without adding to the ratable interests of the shareholders.

Upon a liquidation immediately before the 'stock dividend' the shareholder would have received precisely the same amount as he would have received upon a liquidation immediately after the 'stock dividend'. So far as the paper, or stock certificate, issue is concerned, it is an evidence of an interest already owned and permanently capitalized.

These plain incidents of the transaction have been repeatedly and authoritatively described.

> "The corporate property remains the same after the stock is increased as before, and the interest of each stockholder in the corporate property is also unchanged."
>
> *Kaufman* v. *Charlottesville Woolen Mills Co.*, 93 Va. 673, 675.

> "After a stock dividend a corporation has just as much property as it had before . . . After such a dividend the aggregate of the stockholders own no more interest in the corporation

than before. The whole number of shares before the stock dividend represented the whole property of the corporation, and after the dividend they represent that and no more. A stock dividend does not distribute property, but simply dilutes the shares as they existed before."

*Williams* v. *Western Union Telegraph Co.*, 93 N. Y. 162, 189.

"There is a clear distinction between the ordinary cash dividend, no matter when earned, and a stock dividend declared as in the case at bar. The one is a disbursement to the stockholder of accumulated earnings, and the corportion at once parts irrevocably with all interest therein. The other involves no disbursement by the corporation. *It parts with nothing to the stockholder.* The latter represents not an actual dividend, but certificates of stock which evidence in a new proportion his interest in the entire capital, including such as by investment of accumulated profits has been added to the original capital."

*DeKoven* v. *Alsop*, 205 Ill. 309.

"It is the characteristic feature of a stock dividend that the property of the corporation itself remains unchanged, but that each one of the new shares of the increased capital stock represents a smaller fractional interest than before in the total amount of the corporate property. On the other hand it is the characteristic feature of a dividend declared and paid wholly from the net profits or undivided earnings that it does

diminish the property of the corporation by exactly the amount of the dividend so paid out, while it leaves the fractional interest represented by each share of the capital stock exactly what it was before. *Gibbons* v. *Mahon*, 136 U. S. 549, 559, 560."

*Gray* v. *Hemenway*, 212 Mass. 239.

"The word 'dividends', if unqualified, signifies dividends payable in money. The word 'income' has a broader meaning, but hardly broad enough to include things not separated in some way from the principal. It is not synonymous with 'increase'. The value of stock may be increased by good management, prospects of business, and the like. But such increase is not income. It may also be increased by accumulation of surplus; but so long as that surplus is retained by the corporation, *either as surplus or as increased stock*, it can in no proper sense, be called, income."

*Spooner* v. *Phillips*, 62 Conn. 62, 68. (Italics ours.)

"It is also one of the incidents of a stock dividend that the stockholder, who receives his pro rata proportion of the new issue while he acquires the ownership of more shares, adds nothing to his proportionate ownership of the assets of the corporation. His holding, after the new issue, bears precisely the same ratio to the total of the outstanding shares of the corporation as did his previous holding to the previous total. *Terry* v. *The Eagle Lock Co.*, 47 Conn. 141, 165. The underlying idea of a cash dividend, on the

other hand, is the distribution to shareholders, as the rewards of the corporate enterprise, of a portion of the profits or surplus assets of the corporation. . . . Whatever form the distribution takes, the result always is the reduction of both the corporate assets and surplus by just the amount of the distribution. Something is taken from the corporation and given to the stockholders. That which is distributed becomes released from all corporate control and comes under the dominion of the shareowner."

*Green* v. *Bissell*, 79 Conn. 547, 551.

See also,

*Terry* v. *Eagle Lock Co.*, 47 Conn. 141.

*Brinley* v. *Grou*, 50 Conn. 66.

*Bouch* v. *Sproule*, 12 App. Cas. 385.

*Jones* v. *Evans* (1913), 1 Ch. 23.

In re *Carson*, Irish Reports (1915), Vol. I, p. 321.

*Guinness, Trustee*, v. *Guinness*, Cases Ct. of Session, 5th Series, Vol. 6, p. 104.

*Minot* v. *Paine*, 99 Mass. 101.

*Davis* v. *Jackson*, 152 Mass. 58.

*D'Ooge* v. *Leeds*, 176 Mass. 558.

*Hyde* v. *Holmes*, 198 Mass. 287.

*Brown* v. *Larned*, 14 R. I. 371, 373.

*Billings* v. *Warren*, 216 Ill. 281.

*Lancaster Trust Co.* v. *Mason*, 152 N. Car. 660.

*Great Western Mining &Mfg. Co.* v. *Harris*, 128 Fed. 321, 326.

A genuine dividend constitutes a debt between the corporation and the shareholders;[1*] once declared it may not be rescinded [2*] and an action may be brought on the debt.[1*]

It is otherwise with a stock issue made to shareholders (commonly called a 'stock dividend'), for, as the directors do not divide anything and in substance merely readjust the symbols by which the shareholders own the net assets, they may recall their own action and leave the shareholders without grievance.

In *Staats* v. *Biograph Co.*, 236 Fed. 454, the Circuit Court of Appeals for the Second Circuit, holding that the action of a board of directors in declaring a 'stock dividend' might be rescinded, said (p. 457):

> "In this case it does not escape observation that the plaintiff's right to a stock dividend, if he has such a right and can enforce it, would gain him nothing. We say it would gain him nothing, because, while a stock dividend would increase the number of his shares, it proportionately diminishes the value of each of his shares, leaving the aggregate value as it was before. He acquires the ownership of more shares, but he adds nothing to his proportionate ownership of the assets of the corporation."

The case of *Gibbons* v. *Mahon*, 136 U. S. 549, was one of a will bequeathing stock in a corpora-

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[1*] *King* v. *Paterson*, 29 N. J. L. 504; *Hunt* v. *O'Shea*, 69 N. H. 600; *Lockhart* v. *Van Alstyne*, 31 Mich. 76; *Stoddard* v. *The Shetucket Foundry Co.*, 34 Conn. 542.

[2*] *Beers* v. *Bridgeport Spring Co.*, 42 Conn. 17; *Staats* v. *Biograph Co.*, 236 Fed. 454.

tion and government bonds in trust to pay "the dividends of said stock and the interest of said bonds as they accrue" to a daughter of the testator, and directing that upon her death "the said stocks, bonds, and income shall revert to the estate" of the trustee. The corporation accumulated earnings from time to time, before and after the death of the testator, which were invested in its permanent works and plant. It declared a 'stock dividend' representing these accumulated earnings and the question was whether this 'stock dividend' was income. It was held to be capital and that it should go to the remainderman, only the dividends which might be received on such stock being payable to the tenant for life.

After reviewing the authorities of other jurisdictions, Mr. Justice Gray discussed the nature of a 'stock dividend' (*id.* pp. 559, 560, 569):

> "Therefore, when a distribution of earnings is made by a corporation among its stockholders, the question whether such distribution is an apportionment of additional stock representing capital, or a division of profits and income, depends upon the substance and intent of the action of the corporation, as manifested by its vote or resolution; and ordinarily a dividend declared in stock is to be deemed capital, and a dividend in money is to be deemed income, of each share.
>
> **"A stock dividend really takes nothing from the property of the corporation, and adds nothing to the interests of the shareholders. Its property is not**

diminished, and their interests are not increased. After such a dividend, as before, the corporation has the title in all the corporate property; the aggregate interests therein of all the shareholders are represented by the whole number of shares; and the proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original shares together representing the same proportional interest that the original shares represented before the issue of new ones. . . .

"The resolution is clearly an apportionment of the new shares as representing capital, and not a distribution or division of income. As well observed by Mr. Justice James, delivering the opinion of the Court below: 'Certificates of stock are simply the representative of the interest which the stockholder has in the capital of the corporation. Before the issue of these two hundred and eighty new shares, this trustee held precisely the same interest in this increased plant in the capital of the corporation, that she held afterwards. She merely had a new representative of an interest that she already owned, and which was not increased by the issue of the new shares. A dividend is something with which the corporation parts, but it parted with nothing in issuing this new stock. It simply gave a new evidence of ownership which already existed. They were not in any sense, therefore, dividends for which this trustee had to account to the *cestui que trust*. She stood after the issue of the new shares just as she had stood before; and the

> trustee was obliged to treat them just as she did, namely, as a part of the original, and to pay the dividends to the *cestui que trust*'."

*Gibbons* v. *Mahon* was long held under advisement by the Court, and it is apparent that it was decided after the most thorough consideration. We have quoted at length from the opinion, because the *ratio decidendi* renders unavailing the efforts which have been made to distinguish this case. The Court explicitly rested its decision upon *the essential nature* of the transaction—that is, upon a consideration of the essential quality of a 'stock dividend' based there, as here, on accumulated surplus invested in plant and property and by appropriate resolution permanently classified as capital. The opinion makes it clear that it was not a rule particularly applicable to wills, or trusts, but the nature and effect of the corporate action which determined the conclusion of the Court. If the 'stock dividend' was not receivable as income, when if income the claimant would have been entitled to receive it, it could hardly be said that it should be taxed as income. Had it been income, the *cestui que trust* would have succeeded, but because the Court considered it *not* to be income she lost her suit. If the 'stock dividend' was not income for the purpose of distribution to the beneficiary of the income, we cannot conceive that it could have been regarded, had an income tax law been in operation, as income for the purpose of taxing it.

As already stated, the statements which had been made in the case of *Bailey* v. *Railroad Co.* (22 Wall. 604), to which the Government refers, were carefully considered in the *Gibbons* case.

*Gibbons* v. *Mahon* was an exposition by which the final authority defined to this extent, by exclusion, the meaning of "income". The usual rule is that when a word which has received judicial construction is subsequently used in Federal legislation it should be presumed to have been used in the sense determined by the Court (*Kepner* v. *United States,* 195 U. S. 100, 124; *Latimer* v. *United States,* 223 U. S. 501, 504). The same principle may be applied in construing the Sixteenth Amendment. If there is to be resort to judicial definitions or expositions with respect to what is "income" as distinguished from "capital", we can think of no justification for ignoring the deliberate ruling of this Court. It is to be observed that State decisions, which are invoked for a contrary rule, almost invariably turn on an effort to effect the intention of the testator, or donor in a trust, with respect to the disposition of his property. Rarely are these decisions concerned with the question of what is income in its nature. And there has been a general agreement that 'stock dividends' declared during a trust life estate, which are based on earnings made by the corporation prior to the creation of the trust, are not income,—a position fatal to the contention that stock dividends are income *per se.* (See *Matter of Osborne,* 209 N. Y. 450, 477; *Day* v. *Faulks,* 81 N. J.

Eq. 173.) Thus, in the *Matter of Osborne, supra,* cited by the Government, it was said that to give a 'stock dividend' to the life tenant which was earned prior to the creation of the trust would "shock the sense of justice". But, of course, there would be nothing that was at all shocking if the stock dividend was income *per se* and the life tenant was therefore entitled to it.

It would be extraordinary to disregard the explicit decision, as to what is income, made by this Court before the adoption of the Sixteenth Amendment, and to substitute therefor State views as to the intention of testators.

Moreover, if Congress is authorized to deal in a particular manner with "black", it cannot deal in this manner with "white" by calling it "black". However important the legislative taxing word, it cannot extend a constitutional provision. It cannot add a cubit to a man's stature or a dollar to his income. It is enough to tax one upon what he has received, but if he is to be taxed upon what he has not received, and may never receive,—upon what in truth makes him no richer,—then we submit that some other word must be found to justify this unhappy result than the word "income".

It is frequently said that the shareholder secures new rights or advantages. But the contention will not bear analysis. We are concerned here with the *property interest* represented by the stock in question upon which the plaintiff had been taxed. This stock represents (1)

the right to have the corporate property managed according to the fundamental compact or contract of membership; (2) the right to receive dividends, when duly declared, that is, amounts separated from the corporate assets and vested in the shareholders individually; and, (3) the ratable interest in the aggregate of the corporate assets to which the shareholders would be entitled upon liquidation.

With respect to management, the shareholder's rights are unchanged save to the extent that the accumulated surplus, which is represented by the new stock, is no longer subject to the discretion of the directors in distribution but is classified as capital and must be retained by the corporation as such.

With respect to dividends that may be declared upon this stock,—whenever any such dividend is declared and there is thus segregated from the corporate property an amount which the shareholder receives, he will be taxable accordingly.

With respect to the right to receive his ratable interest upon a winding-up, there is no change.

It is argued that the effect is the same as though a cash dividend had been declared, and its amount received by the defendant-in-error, and she had then invested this amount in the new stock. The same argument was made unavailingly in *Towne* v. *Eisner*. It is manifest that the two things mentioned, instead of being the same, are different, both legally and practically. When the cash dividend is declared and the amount is received, the shareholder obtains something which he

owns and which he may reinvest or not as he pleases. He receives property in his exclusive ownership, and he exercises the freedom of choice. In the case of a 'stock dividend', he obtains nothing but an evidence of what he already owns; he has no freedom to invest or not invest; and the investment is permanently capitalized. This distinction was pointed out in *Davis* v. *Jackson*, 152 Mass. 58.

It is argued further that the certainty that these earnings of the corporation could thenceforth never be distributed as dividends, was a valuable assurance of the continued solvency of the company to the stockholder, and that this assurance was subject to a tax as income of the individual shareholder. But before the 'stock dividend' the shareholder's interest in the corporate assets could not be taken away, except through mismanagement or losses, and his interest continues to be subject to these contingencies as before. Previously, if there were distribution in cash, he would receive his dividend and own the amount. The proposition that the certainty that a man will never receive a given fund is equivalent to his actual receipt of that fund will appeal less to the shareholder's sense of logic than to his sense of humor.

Nothing could be a greater fallacy than to treat a recipient of a 'stock dividend' as being in the position of a recipient of a like amount of cash. In fact, he may never receive anything but a piece of paper, for the corporation may become insolvent and his stock worthless. In the present case, the shares had a

market value and, as might be expected, the market value of all the shares remained unchanged. But it may be, and frequently is, the case that at the time of the 'stock dividend' the shares do not have a market value, or have a market value below par. The corporation may have a surplus, and may capitalize it, but it may be engaged in a hazardous enterprise or for other reasons its shares may not have a value corresponding to their book value. Illustrations of this may readily be found. There are to-day selling on the New York Stock Exchange shares which are below par, although the corporation has a surplus and could issue 'stock dividends'. Such 'stock dividends' would not only make the shareholders no richer, but the latter would have to pay a tax, under the contention of the Government, as an income tax upon an assumed or par value which was greater than the actual value of the shares themselves. The fact that the corporation may have accumulated profits, or surplus, does not mean that the shareholders can realize that amount. It is a misnomer to call 'stock dividends' a *distribution;* it is not a distribution but a capitalization. The capitalization of surplus does not transfer it to shareholders. If the new shares have market value, the 'stock dividend' will make the shareholders no richer, and, if the shares have no market value, the shareholders will not be able to realize even that which they are falsely assumed to have received.

The argument that a 'stock dividend' is income fails to distinguish between the effect of the dollar

sign printed on the certificates of stock as indicating the amount contributed to "capital", and the interest of the shareholder in the aggregate corporate assets, with which this dollar sign, or the par value of his shares, has nothing to do. As to the corporation, its net assets are divided into two groups, "capital" and "surplus", with different legal attributes, and the dividing line between the two groups is shown by the nominal or par value of the company's stock, or the amount of the contributed "capital".

In the case at bar, for example, the Standard Oil Company of California had $49,686,656 of capital stock, and $94,538,919. of assets. The $49,686,656 of capital was divided into 496,866 shares of the par value of $100. each. These $49,686,656 represented, in a general sense, a trust fund to be used by the corportion in the conduct of its business and for the payment of its debts; none of it could lawfully be separated from the company and paid to its shareholders. The other $44,852,263. of its assets represented surplus which the company was free to dispose of in any manner that it saw fit. There were 496,866 shares of stock outstanding; the dollar mark on each certificate, indicating the par value of each share, was of importance in indicating the amount of the contributed capital stock, and therefore the dividing line between these two groups of its net assets.

But there was no such distinction with regard to the shareholder's interest in the aggregate corporate assets. As to this the dollar mark on his certificate

was immaterial. Each share of stock represented 1/496,866 part of the net assets of the corporation, and those assets might amount to $1,000,000. or $50,000,000, and this was true whether his stock had a nominal par value or whether, as is permitted in various States, it was "no par value" stock.

When it is argued that in receiving a 'stock dividend', a shareholder receives from the corporation something of value which must therefore be income, there is an inaccuracy in terms. If I exchange a two-dollar bill with the money changer for two one-dollar bills, I have, it is true, received from him something of value, but my property interest remains entirely unchanged, and I have surely not received any "income".

If the Standard Oil Company of California had outstanding 496,866 shares of capital stock of the nominal or par value of $100. each, and had issued in exchange therefor 993,732 shares of the nominal or par value of $50. each, each shareholder would have received an increased number of tangible evidences of his ownership in the assets of the corporation. He would have no greater interest in the assets of the corporation than he had before, and the dividends he might thereafter receive on his holdings of $50. shares would be just as large as if he received dividends on his original $100. holdings. But the Government would not contend that such an alteration of the shareholder's certificates constituted income.

It undoubtedly will be conceded by the Govern-

ment that if a corporation having a million dollars of capital and with no surplus, waters its stock and issues a 50 per cent. 'stock dividend' to its shareholders, the new stock, not representing an increase of assets, would not constitute taxable income in the hands of the shareholder; the receipt by the shareholder of certificates of stock having an increased nominal or par value does not increase the stockholder's real interest in the corporation, and therefore the change does not constitute income.

The effect of this concession cannot be overcome. It is conceded that the increase of the number of shares into which the assets of the corporation are divided, or the issue of a new series of fractional certificates, does not constitute income to the shareholder if the corporation has no accumulated surplus, even though the nominal or par value of the shares of stock owned by each shareholder is thereby increased. It is conceded that mere increase in the number of shares into which the capital of a corporation is divided does not constitute income, and this regardless of the question whether the corporation has available accumulated surplus or not. And it is just as true that the shareholder's interest in the aggregate corporate assets remains unchanged when there is an increase of stock based on accumulated surplus. The change is simply that the amount is permanently capitalized so that it cannot be distributed without liquidation; on liquidation the shareholder would receive no more than before.

Of course the salability of the new shares presents no more argument for the existence of "income" than does the salability of the old shares at an increased price because of the accumulated earnings back of them. A sale in either case would have the same effect.

If one had 9,000 shares previously, and received 4,500 additional shares through a 'stock dividend' based on surplus accumulations, he of course, could sell any portion of the total 13,500 shares. And if he sold 4,500 of the 13,500 shares he would receive the equivalent in cash. But he could have realized the same amount prior to the 'stock dividend' by selling 3,000 shares of his original 9,000 shares. His intrinsic interest is the same, and the transaction has not affected its value.

The Government says that " 'income' represents the advantage, service or use actually rendered by 'capital' to its owner during a period of time". Such a definition leads one quite afar. Thus a very important 'service' or 'advantage' of capital, which every business man would be swift to recognize, is the advantage or service that it gives in enabling him to have a line of credit at his bank. He gives his bank a statement of his resources and he is allowed a line of credit "during a period of time". If, at the end of this 'period' he is able to make good his obligations but has no gain, it would strike him as extraordinary to say that this line of credit constituted 'income' on which he should pay a round sum to the Government

through an income tax. Perhaps, following the analogy of the present case, if a man had a line of credit for a year of $100,000 he should pay an income tax upon this 'advantage' or 'service' of his capital as amounting to $100,000.

A better definition, which embraces the essential element of *'gain'*, is found in *Stratton's Independence* v. *Howbert*, 231 U. S. 399, 415, where it is said:

> "'Income' may be defined as the gain derived from capital, from labor, or from both combined."

This definition was reaffirmed in *Doyle* v. *Mitchell Brothers Co.*, 247 U. S. 179, 185, where it is said that

> "Whatever difficulty there may be about a precise and scientific definition of 'income', it imports, as used here, something entirely distinct from principal or capital either as a subject of taxation or as a measure of the tax; conveying rather the idea of gain or increase arising from corporate activities. As was said in *Stratton's Independence* v. *Howbert*, 231 U. S. 339, 415: 'Income may be defined as the gain derived from capital, from labor, or from both combined.'"

Or, it may be said, quoting the language of Professor Seligman:

> "Strictly speaking, income as contrasted with capital denotes that amount of wealth which flows in during a definite period and which is at the disposal of the owner for purposes

> of consumption, so that in consuming it, his capital remains unimpaired." (Seligman on Income Tax, p. 19.)

Of course it is not denied that income may be in the form of property, although it is well settled that in construing an Income Tax Act income is taken to mean money in the absence of any special provision of law to the contrary, and not the mere expectation of receiving it (*United States* v. *Shillinger,* 14 Blatchf. 71). If, however, the Act reaches property and not simply money, it must still be property that constitutes *'gain'* or, *'income'*. It is not 'income' simply because it is property.

The Courts have always recognized that mere appreciation in value of capital assets is not to be called income.

> "The mere fact that property has advanced in value between the date of its acquisition and sale does not authorize the imposition of the tax on the amount of the advance. Mere advance in value in no sense constitutes the gains, profits, or income specified by the statute. It constitutes and can be treated merely as increase of capital."
>
> *Gray* v. *Darlington,* 15 Wall. 63, 66.*

*Under the British Income Tax Act (16 & 17 Vict. c. 34) it is established that applications in value of capital assets, even after the realization of profits by sale, do not constitute taxable income except in cases of transactions by dealers or other persons who buy and sell for purposes of profits. *Tebrau (Johore) Rubber Syndicate, Limited,* v. *Farmer,* S. T., 5 Income Tax Cases, 658; *Stevens* v. *The Hudson's Bay Company,* 5 Income Tax Cases, 424; *The Assets Company, Ltd.* v. *The Inland Revenue,* Cases in the Court of Session, 4th Series, Vol. 24, p. 578.

In the words of Mr. Justice McKenna in *Lynch* v. *Turrish*, 247 U. S. 221, 231, speaking with approval of *Gray* v. *Darlington*:

> "Indeed, the case decides that such advance in value is not income at all, but merely increase of capital and not subject to a tax as income."

In the case of the *Baldwin Locomotive Works* v. *McCoach* (3 C. C. A. 1915), 221 Fed. 59, which arose under the Corporation Tax Law of 1909, which measured the tax by the income of the corporation, the Court said:

> "We agree with the District Court that this increase of valuation was not income within the meaning of the statute. Nothing whatever was added to the corporate property, which remained exactly the same after the appraisement as before. The only thing done was to put upon the company's books an expression of expert opinion that certain property was worth a certain sum, and this can hardly be said to be income, or even gain, in any proper sense. The company could not become either richer or poorer by making a few book entries that merely recorded a new estimate of how much it was worth."

Exactly the same situation is presented when the market value of a share of stock increases because of accumulated earnings. Until *separation* takes place, which happens when a cash dividend is declared, there is no taxable income. Again the courts have recognized that such appreciation is not income, for nothing

has come in, part of which can be taken by the government for revenue purposes.

In *Lynch* v. *Hornby*, 247 U. S. 339, the Court said, through Mr. Justice Pitney, in reference to the undivided surplus:

> "As to these, however, just as we deem the legislative intent manifest to tax the stockholder with respect to such accumulations only if and when, and to the extent that, *his interest in them comes to fruition as income,* that is, in dividends declared" (p. 343; italics ours).

Finally, the same reason exists for holding that 'stock dividends' shall not be included within the term "income". It is not necessary to show again what happened when the Standard Oil Company of California declared its 'stock dividend', it is merely sufficient to show that the defendant in error has not received anything with which to pay the tax. She has received new shares but her old shares represented precisely the same value; in fact she is no richer at the end of the year than at the beginning; and as in all the cases discussed above, the one thing necessary has not taken place—realization of gain. She may never realize any gain. Whether she does or not will depend on the ultimate liquidation so far as the shares themselves are concerned. If dividends are received *on* the new shares, so that she does receive gain in this way, she will be taxable on such dividends. But until that point is reached the plaintiff is immune from taxation under an income tax

law. She objects to the payment of a tax as having received some income when just the opposite thing has happened—she has been definitely assured that she will not receive it.

It is submitted therefore that when Congress was authorized to tax "incomes" it was not the intention to allow it to tax a change in the evidence of ownership which is all that a 'stock dividend' represents.

**It is submitted that the judgment of the District Court should be affirmed.**

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